U.S. TRADE RELATIONSHIPS WITH THE SOVIET UNION AND EASTERN EUROPE, THE IMPLICATIONS OF "EUROPE 1992" ON AMERICAN DIRECT INVESTMENT, AND FOREIGN INVESTMENT IN THE UNITED STATES

HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

LONG-TERM STRATEGIES FOR PROGRAMS AND ISSUES WITHIN THE JURISDICTION OF THE COMMITTEE

JANUARY 24, 25, 30, 31; FEBRUARY 28;
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FOREIGN INVESTMENT IN THE UNITED STATES

WEDNESDAY, JANUARY 24, 1990

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met, pursuant to call, at 9:30 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[The press releases announcing the hearing follow:]

FOR IMMEDIATE RELEASE
TUESDAY, DECEMBER 19, 1989

PRESS RELEASE #19
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A SERIES OF HEARINGS TO EXAMINE U.S. TRADE RELATIONSHIPS WITH THE SOVIET UNION AND EASTERN EUROPE, THE IMPLICATIONS OF "EUROPE 1992" ON AMERICAN DIRECT INVESTMENT, AND FOREIGN INVESTMENT IN THE UNITED STATES

The Honorable Dan Rostenkowski (D., Ill.), Chairman of the Committee on Ways and Means, U.S. House of Representatives, today announced that the Committee will hold a third set of hearings as part of its continuing series to consider long-term strategies for programs and issues within the jurisdiction of the Committee. The purpose of these hearings is to examine U.S. trade relationships with the Soviet Union and Eastern Europe, the implications of "Europe 1992" on American direct investment, and foreign investment in the United States.

During the first two days of hearings, Wednesday, January 24, beginning at 9:30 a.m., and Thursday, January 25, 1990, beginning at 10:00 a.m., in the Committee's main hearing room, 1100 Longworth House Office Building, the Committee will receive testimony from Administration witnesses from the Departments of State, Commerce, and Treasury and from the Office of the United States Trade Representative on each of these important issues. The hearings will continue in the same room on Tuesday, January 30, beginning at 9:30 a.m., when the Committee will hear from private sector witnesses on trade with the Soviet Union and Eastern Europe and Europe 1992, and on Wednesday, January 31, at the same time and place, will conclude with testimony from the public sector on foreign investment issues.

In announcing these hearings, Chairman Rostenkowski commented: "The first two hearings in this series provided Members of the Committee with an opportunity to examine important national issues without the pressure of contemporaneous legislation. This set of hearings will allow the Committee to study, in depth, three major issues which have far-reaching trade and tax implications in the United States. These hearings should provide the Committee with a better understanding of these complex issues and will help the Committee to formulate appropriate responses to these initiatives in the future."

Each of these issues is discussed in greater detail below:

U.S. TRADE RELATIONSHIPS WITH THE SOVIET UNION AND EASTERN EUROPE

In recent weeks and months, a change of historic proportions has taken place in the Soviet Union and Eastern Europe. The fundamental structure of the postwar order is being changed on a nearly daily basis, in ways which could not have been anticipated just one year ago. Presidents Bush and Gorbachev have just concluded one Summit meeting in Malta, with another planned for June of next year. The focus of these meetings, and others at the Cabinet and subcabinet levels, is broad in scope, with economic to security matters all subject to reassessment and possible change.

Since the Committee on Ways and Means is the primary committee of jurisdiction in the House of Representatives on international trade matters, it would be the first committee in the Congress to consider any trade agreement and proclamation extending most-favored-nation (MFN) status to the Soviet Union. Similarly, any action taken by the Administration with respect to Eastern European countries under authority of Title IV of the Trade Act of 1974 would be of interest to and potentially subject to the approval of the Committee on Ways and Means.

In light of recent developments, including the President's statements at the Malta Summit concerning negotiation of a trade agreement with the Soviet Union, it is clear that Congress and this Committee soon will be faced with the need to consider the whole range of U.S. economic relations with the Soviet Union, including that country's MFN status. With events proceeding as they are in Eastern Europe, it is conceivable that the United States will be faced with a similar need to reassess our economic and trade relations with other Eastern European countries in the not too distant future.

One of the objectives of these hearings is to assess the prospects for improved economic and trade relations with the Soviet Union and other Eastern European countries. Such an assessment would appropriately include discussion of plans and prospects for a waiver under Title IV and extension of MFN status to the Soviet Union.

IMPLICATIONS OF "EUROPE 1992" ON AMERICAN DIRECT INVESTMENT

In 1985, the European Commission announced its plan to complete formation of a single internal market in the European Community (EC) by December 31, 1992 (Europe 1992). The EC is currently in the process of considering and acting upon a series of almost 300 directives that are necessary to achieve economic integration. The directives fall into three main categories: elimination of physical (customs or frontier) barriers between countries; elimination of technical barriers (through harmonization of standards, testing, and certification); and elimination of fiscal barriers (harmonization or closer approximation of tax rates among member states). At the present time, the EC Commission has proposed approximately 90 percent of the necessary directives and the EC Council of Ministers has approved more than 55 percent of the directives.

Fiscal barriers have been widely regarded as one of the most difficult aspects of the Europe 1992 plan. The EC Commission has acknowledged, however, that in order to achieve a truly integrated market, discrepancies in fiscal policies have to be minimized, especially indirect taxes, such as value added taxes (VATs) and excise taxes. Currently, each of the EC countries has its own system of taxation, which, in turn, requires fiscal frontier controls for collection and enforcement of taxes (i.e., VAT and excise duties). Overall rates in different countries vary substantially and similar goods are treated differently in each country.

While prospects for market expansion based on increasing integration appear promising for U.S. exporters and investors, the EC has not yet clearly detailed many of the ways in which the 1992 plan will affect non-EC trading partners. It is important that the U.S. Government and private businesses pay close attention to the progress of developments in the EC on the issues of economic unification. There is some uncertainty about the development of "Fortress Europe" with particular concerns about local content rules, reciprocity, quotas, technical standards, rules of origin, and transition rules.

The potential effects of Europe 1992 on U.S. economic interests are difficult to determine at this stage. U.S. firms are clearly concerned about developing strategies for competing successfully in the European market. At the same time, the Congress must consider these concerns in the context of broader U.S. international and domestic economic interests. One focus of these hearings will be to study the effects of the Europe 1992 plan on American direct investment. In addition, the Committee will be interested in hearing testimony on the changing investment strategies of U.S. firms and the business strategies, including tax strategies, being undertaken in order to respond to the changing European market.

Some analysts argue that the Europe 1992 plan is distorting investment flows by causing foreign firms to invest in Europe when they might not do so otherwise. Recent data also indicate that capital spending by U.S. firms in Europe was strong in 1988, and plans indicate additional increases in 1989 and 1990.

Some economists argue that protectionism, whether potential or real, is not a major factor influencing foreign investment decisions. Other factors are considered more important, including relative rates of economic growth in Europe and the United States, changes in exchange rates, and the overall business strategy of individual firms. The Committee is interested in developing a better understanding of the extent to which U.S. business decisions, including new and expanded investment strategies, are being influenced by specific or general developments in the EC.

FOREIGN INVESTMENT IN THE UNITED STATES

The decade of the 1980's has seen a significant surge in the amount of foreign investment in the U.S. economy. For the first time since World War I, the United States in 1985 became a net international debtor as foreign capital inflows far exceeded U.S. capital outflows. The U.S. net international investment position in 1981 was $141 billion. By 1988, that U.S. position had fallen to a $532 billion deficit. 1988 data indicate that foreign holdings in the United States amount to $1.8 trillion, which comprises some six percent of U.S. wealth. If the current rate of growth continues, the Congressional Research Service estimates that the U.S. net-debtor position could reach $700 billion in 1990, and close to $1 trillion by the mid-1990s.

The merits of foreign investment in the United States have been vigorously debated in recent years. It is appropriate at this time that the Committee make a serious and thoughtful study of this issue. Among the issues the Committee is interested in exploring are the causes of the increased inflow of foreign investment into the United States and its implications for the U.S. economy. What is the relationship between the U.S. fiscal deficit, the trade deficit, and the inflow of foreign capital? To what extent does foreign investment result in increased economic growth and employment, and to what extent does it limit the flexibility of U.S. economic policies and U.S. control over its own economic future?

Our current tax policy towards foreign investment was developed at a time when the amount of foreign investment in the United States was significantly smaller, and the United States was a net creditor nation and net capital exporter, rather than a net debtor nation and a net capital exporter. This is an appropriate time for the United States to reappraise current tax policy toward foreign investment in the United States in light of these changes in our economic and trade positions. The Committee must also carefully consider the ramifications for the U.S. economy and U.S. international obligations, including in the General Agreement on Tariffs and Trade (GATT), of proposals to modify U.S. tax policy that would restrict or otherwise discourage the flow of foreign investment into the United States.

The Committee will receive testimony from several invited witnesses as to the amount and nature of foreign investment in the United States today and the treatment of foreign investment under the U.S. tax system. In addition, the Committee requests testimony on these issues from other witnesses who can assist in this analysis.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Requests to be heard must be made by telephone to Harriett Lawler or Diane Kirkland [telephone (202) 225-1721] by close of business Friday, January 12, 1990. The telephone request should be followed by a formal written request to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, room 1102 Longworth House Office Building, Washington, D.C. 20515. The Committee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Committee office [(202) 225-1721].

In view of the limited time available to hear witnesses, the Committee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearings. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

Witnesses scheduled to present oral testimony are requested to briefly summarize their written statements. The full statement will be included in the printed record.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, witnesses scheduled to appear before the Committee are required to submit 200 copies of their prepared statements to the Committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of their scheduled appearance. Failure to do so may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Any interested person or organization may file written comments for inclusion in the printed record of the hearings. Persons submitting written comments for the printed record should submit at least six (6) copies of their comments by the close of business Tuesday, February 20, 1990, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, room 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing a written statement for the record of the printed hearings wish to have their statement distributed to the press and the interested public at the hearings, they may provide 150 additional copies for this purpose to the Committee office, room 1102 Longworth House Office Building, prior to the start of the public hearings.

SEE FORMATTING REQUIREMENTS BELOW:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

* * * * * * * * * * * *

FOR IMMEDIATE RELEASE
TUESDAY, FEBRUARY 20, 1990

PRESS RELEASE #26
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES THE CONTINUATION OF HEARINGS TO EXAMINE U.S. TRADE RELATIONSHIPS WITH THE SOVIET UNION AND EASTERN EUROPE, THE IMPLICATIONS OF "EUROPE 1992" ON AMERICAN DIRECT INVESTMENT, AND FOREIGN INVESTMENT IN THE UNITED STATES

The Honorable Dan Rostenkowski (D., Ill.), Chairman of the Committee on Ways and Means, U.S. House of Representatives, today announced the continuation of hearings to consider long-term strategies for programs within the jurisdiction of the Committee. Administration witnesses will appear for further discussion of U.S. trade relationships with the Soviet Union and Eastern Europe, the implications of "Europe 1992" on American direct investment, and foreign investment in the United States.

In announcing the dates for the appearance of the Administration's witnesses, Chairman Rostenkowski stated: "The Committee received a large volume of testimony from private sector witnesses earlier this month on the rapid changes occurring in all the areas which are the subject of these hearings, particularly developments in Eastern Europe and the Soviet Union. United States trade and economic policies toward that region must be reassessed and, where appropriate, changed to respond in a positive fashion. European Community (EC) unification efforts are reaching a new plateau, with many potential benefits, but some possible costs, likely to flow to the EC's trading partners. Among the areas of concern is how EC-92 programs as implemented will affect the investment decisions of U.S. firms. Finally, the United States continues to receive a massive flow of capital from abroad. A key question is whether such foreign investment inflows should be a matter of concern to the United States. The Committee looks forward to receiving the views of the Administration on these critical issues."

The following Administration witnesses have been scheduled to appear. The hearings will take place in the main Committee hearing room, 1100 Longworth House Office Building.

Wednesday, February 28, beginning at 2:30 p.m.:

The Honorable Carla Hills, U.S. Trade Representative

Thursday, March 1, beginning at 10:00 a.m.:

The Honorable Robert A. Mosbacher, Secretary of Commerce

Thursday, April 19, beginning at 10:00 a.m. (tentative):

The Honorable James A. Baker, Secretary of State

Thursday, April 19, beginning at 2:00 p.m.:

The Honorable Nicholas Brady, Secretary of the Treasury

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*** * * NOTICE -- CHANGE IN SCHEDULE * * ***

FOR IMMEDIATE RELEASE
THURSDAY, MARCH 29, 1990

PRESS RELEASE #26-REVISED
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BLDG.
WASHINGTON, D.C. 20515
TELEPHONE: (202) 225-1721

THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A CHANGE IN SCHEDULE FOR THE HEARINGS TO EXAMINE U.S. TRADE RELATIONSHIPS WITH THE SOVIET UNION AND EASTERN EUROPE, THE IMPLICATIONS OF "EUROPE 1992" ON AMERICAN DIRECT INVESTMENT, AND FOREIGN INVESTMENT IN THE UNITED STATES

The Honorable Dan Rostenkowski (D., Ill.), Chairman of the Committee on Ways and Means, U.S. House of Representatives, today announced a change in schedule for the hearings at which Administration witnesses will appear for further discussion of U.S. trade relationships with the Soviet Union and Eastern Europe, the implications of "Europe 1992" on American direct investment, and foreign investment in the United States. (See also press release #26, dated February 20, 1990, and press release #19, dated December 19, 1989.)

Administration witnesses, originally scheduled for April 19, 1990, have been rescheduled to appear as follows:

Wednesday, April 18, beginning at 10:00 a.m.:

The Honorable James A. Baker, Secretary of State

Wednesday, April 18, beginning at 2:00 p.m.:

The Honorable Nicholas Brady, Secretary of the Treasury

The hearings will take place in the main Committee hearing room, 1100 Longworth House Office Building.

DETAILS FOR SUBMITTING WRITTEN COMMENTS FOR THE RECORD:

Any interested person or organization may file written comments for inclusion in the printed record of the hearings. Persons submitting written comments for the printed record should submit at least six (6) copies of their comments by the close of business Monday, April 30, 1990, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, room 1102 Longworth House Office Building, Washington, D.C. 20515.

SEE FORMATTING REQUIREMENTS BELOW:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

Chairman **Rostenkowski**. The committee will come to order. Good morning. This hearing is the third in a continuing series of hearings by the Committee on Ways and Means to consider issues of long-term importance to programs under the jurisdiction of this committee. Over the course of 4 days, we will receive testimony from a large number of witnesses on three major topics: the causes and implications of foreign direct investment in the United States; the impact of EC–1992 on United States-direct investment and United States companies, and future prospects for United States-trade relations with the Soviet Union and Eastern Europe.

I am disappointed to report that no representatives of the administration will be testifying at these hearings. We had invited the U.S. Trade Representative and the Secretaries of State, Commerce, and the Treasury to appear before us. However, due to the fact that the President's State of the Union Address will take place on January 31—the last day of these hearings—these Cabinet members withdrew their prior commitment to testify. This recent development is a regrettable one, particularly in view of the importance of these issues to both the administration and the Congress.

I do not view these hearings as an attempt to reach a legislative consensus on the issues under consideration. What I hope we will achieve is a solid understanding of the complexities involved, which will give us a better foundation for assessing the policy implications of these matters in the future as specific legislative measures come before the committee.

The issue of foreign direct investment in the United States will be the focus of these hearings during the next 2 days. Foreign investment in the United States has increased rapidly in recent years and has prompted a growing level of concern on the part of some members of the public and the Congress.

Questions have been raised about the extent to which heavy reliance on foreign investment limits the flexibility of our economic policymakers to establish policies responding primarily to domestic economic developments. Several experts analyzing the 77-point drop in the stock market on Monday attributed the drop to rising interest rates and growing fears that foreign investors may be decreasing their investments in the United States. If true, these developments demonstrate the importance of foreign investment to the U.S. economy.

Concerns also have been voiced that foreign direct investment may result in the loss of control of key economic sectors or technologies. Voices on the other side of this debate point to the benefits that such investment brings to the U.S. economy—capital to finance our domestic investment needs; improved management skills; and new technologies, to name just a few.

One purpose of these hearings is to examine the reasons for the recent increase in foreign investment in the United States and its policy implications. Should we be concerned about the current level of investment? How do our major trading partners treat U.S. investors in their countries?

A second purpose of the hearings is to examine current U.S.-tax policy toward foreign investment. Our tax policy was formulated at a time when the level of foreign investment in this country was much smaller and when the United States was a net capital exporter to the rest of the world. The United States is now a net capital importer and a net debtor nation, and it would appear to be appropriate to ask whether U.S.-tax policies should be reexamined in light of these changed circumstances.

I wish to stress that the Committee on Ways and Means approaches these issues with no preconceived notions or bias. We recognize that there are many benefits that flow from increased foreign investment, just as there are concerns. The United States remains one of the world's largest foreign investors, and we must keep in mind that proposals to alter our own position toward such investment should be looked at with an eye to how we would react if those same policies were applied to our companies overseas.

Our first witnesses today are our colleagues from the House, including a respected member of the Committee on Ways and Means, the Honorable Bill Gradison of Ohio, who will be testifying on U.S.-trade relations with Europe and Japan. He is joined by Congressman Tom Campbell of California and Congressman John Bryant of Texas, both of whom will testify on the issue of foreign investment.

In light of the large number of witnesses scheduled to appear at these hearings, I request all of our witnesses to limit their oral remarks to 5 minutes, so that we may have sufficient time for questions. The written testimony of all witnesses will be included in its entirety in the record.

Mr. Gradison, you may begin. The committee looks forward to hearing your testimony.

Before I recognize our colleagues, I would like to yield to my colleague, Mr. Archer.

Mr. **Archer**. Mr. Chairman, I join in welcoming the witnesses today and our guests in the audience.

It is indeed an appropriate time for the committee to hold these hearings to assist in developing a possible legislative agenda for the coming year, and to review important and timely issues as part of our oversight responsibilities in this area.

With the massive changes taking place throughout Eastern Europe, and the reformations occurring within the U.S.S.R., it is imperative that we review United States policies to ensure that we are as well positioned as possible to support positive social and economic goals in the Eastern bloc. The political and social reforms which we all applaud will ultimately be only as strong as their economic underpinning will allow.

Adding to the challenge of addressing that complex set of issues is the fact that the European communities are moving steadily toward the goal of full economic integration in 1992.

Importantly, we have the final phase of the Uruguay round of multilateral trade negotiations entering a critical period. These negotiations must be successfully concluded this year if we are to move into the future with an effective blueprint for a multilateral trading system.

Within that context, these hearings will address three broad interrelated elements within our committee's jurisdiction: First, foreign investment in the United States, on which the hearing will focus primarily today, is under increasing scrutiny, from the standpoints of both our own economy and in terms of the effects of investment restrictions on international trade.

In the present context of the Uruguay round, any protectionist-appearing restrictive moves with respect to foreign investment will send the wrong signal to our trading partners at a delicate stage of the negotiations.

The two other topics under consideration are EC-1992 and East/West trade, which will be addressed when the hearings continue this week and next.

The impending integration of the European market raises questions of both challenge and opportunity. Widely viewed as a means of simplifying conditions for trade with the EC, and within the EC itself, a degree of uncertainty remains as to the ultimate effect of the single market on U.S. businesses seeking to operate or export there after 1992.

The exciting changes taking place in Eastern Europe pose perhaps our greatest international challenge today. I look forward to hearing from our witnesses on the essential question of the avenues which we should explore, as members of this particular committee of the Congress, in our strong desire to help the citizens of those nations sustain the dream of freedom.

Mr. Chairman, I would like to conclude my remarks by emphasizing once again how important it is that we consider these issues in the context of the relationship they have to one another. We cannot view foreign investment in the United States in a vacuum.

We cannot isolate decisions we make in regard to Eastern Europe from related decisions in the Uruguay round. Nor can we objectively view the challenges and opportunities of EC-1992 without regard to an emerging Eastern Europe and our role in shaping multilateral trade agreements.

Thank you very much.

Chairman ROSTENKOWSKI. Mr. Thomas.

I am sorry; Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman.

I salute you for devoting these first weeks of the second session to a broad view of domestic and international economic and political activities. We do not make policy in a vacuum, and rapidly changing events here and abroad have created historic opportunities and challenges for U.S. policymakers.

To paraphrase the late President Franklin Roosevelt, we need all of the minds we have and all that we can borrow in the year ahead.

I am confident that our distinguished group of witnesses will make a significant contribution to our future deliberations, and I look forward to receiving their testimony.

Chairman ROSTENKOWSKI. Mr. Schulze.

Mr. SCHULZE. Mr. Chairman, I commend you for holding these hearings and ask unanimous consent to have my statement submitted for the record.

[The statement of Mr. Schulze follows:]

STATEMENT OF HON. DICK SCHULZE

First of all, I would like to commend you, Mr. Chairman, for having the foresight to hold this set of hearings. The topics to be addressed are timely, critical, and will undoubtedly have a profound impact on the global trading order. Accordingly, I would like to comment briefly on each.

With the ongoing brisk pace of foreign direct investment in the United States, various explanations for this activity have been spawned. Supporters of foreign investment in the United States claim that it creates jobs, opens up additional opportunities for U.S. suppliers, and shows the relative attractiveness of the U.S. economy. Detractors say that foreign investment amounts to nothing more than the United States being bought up by foreigners, it has grave national security consequences, and that it actually exacerbates the trade deficit.

Personally, I view the increase in foreign investment as a concrete example of just how interdependent the world's trading nations are becoming—and I see that as a generally positive development. I am deeply concerned however that, for as open as America is to foreign investors, U.S. investors are not granted symmetrical investment access overseas, especially in Japan. In the 1988 trade bill, the Congress gave the administration the tools to tear down foreign barriers to U.S. goods and investment. I would urge the administration in the strongest possible terms to take full advantage of this authority.

Regarding Europe 1992, we have all heard horror stories about U.S. firms essentially being forced to locate manufacturing facilities in Europe to keep from being locked out of post-1992 Europe. These firms are genuinely concerned that the EC's proposals regarding local content, rules of origin, and government procurement are unfairly and artificially distorting investment flows. And what about the $50 million mid-sized company which currently enjoy strong export sales to Europe, but simply cannot afford to set up a $200 million facility in Europe in order to meet pending local content or rules of origin requirements. Are we going to sit idly by while the European Commission squeezes the life out of these firms?

Lastly is the issue of East-West trade. Given recent events in the Soviet Union and Eastern Europe, increasing attention is being paid to how U.S. trade policy vis-a-vis these nations should change. There has even been discussion at the highest levels of the U.S. executive and legislative branches about granting most-favored-nation trade status to the Soviet Union. However, I urge extreme caution in this area. For, as much autonomy as the Soviet Union has accorded its East bloc allies, it has done so out of economic necessity, not some newfound altruism. The real test is how General Secretary Gorbachev deals with the cries for freedom coming from within the Soviet Union's own borders, namely in the Baltic States of Lithuania, Latvia, and Estonia. So far, in my opinion, Mr. Gorbachev is failing this test.

Again, Mr. Chairman, thank you, and I look forward to receiving the testimony.

Chairman ROSTENKOWSKI. Mr. Gradison, you may begin.

STATEMENT OF HON. BILL GRADISON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Mr. GRADISON. Mr. Chairman, I do appreciate this opportunity to testify on the future direction of the U.S.-trade policy. This is an appropriate time for these hearings given the current state of the Uruguay round negotiations of the General Agreement on Tariffs and Trade [GATT], the evolution of the European Community's 1992 program, and the dramatic changes taking place in Eastern Europe. Our priorities should be to break down the trade barriers affecting the greatest amount of trade and to reduce our trade imbalances.

I believe the best way to reduce trade barriers is through the establishment of a free-trade-zone program compatible and complementary to the GATT. The focus would be to negotiate free trade agreements [FTA's] similar to the ones we have negotiated with Canada and Israel with priority given to our major trading partners. This could be done in one set of negotiations, creating a FTA for the Organization for Economic Cooperation and Development [OECD],[1] or it could be done on a bilateral basis, one group at a time, starting with the European Community [EC] and Japan and then adding other industrialized nations such that might be interested in similar agreements. Because countries that might not want to be left out of free access to their major trading partners, there would be a definite incentive to negotiate such FTA's and to make concessions that they might not otherwise make in the framework of a multilateral negotiation with more limited goals. The end result of these negotiations could have a dramatic impact on the world economy.

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[1] The Organization for Economic Cooperation and Development is comprised of Australia, Austria, Belgium, Canada, Denmark, the Federal Republic of Germany, Finland, France, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

I believe the first step should be to announce our desire to negotiate a free-trade agreement with the EC and Japan. I expect that enormous gains in economic efficiency would result from a European Community-United States-Japan FTA. These gains would result from having much freer access to what will be, after the 1992 program is finalized, the world's largest unified market and the Japanese market which is the second largest national market in the world and from the higher level of trade that will result from the removal of trade barriers.

An FTA with Western Europe and Japan would also cut across the regional trading blocks many analysts are concerned may develop in the near future. These blocks, Europe, North American and the Asian Rim, pose a threat to the continued trade growth. We need to search now for effective ways to prevent their continued development. FTA's that cut across the grain of the nascent trade blocks would do just that.

Some might feel that this is the wrong time to consider the FTA with the EC because the Uruguay round is still underway and the EC 1992 program is not yet complete. However, as Georgetown University Prof. Gary Hufbauer has pointed out in a recent article, an announcement could be made at the 1991 economic summit, after the conclusion of the Uruguay round, for negotiations to begin in 1993 after the EC–1992 program has been finalized.[2] If the negotiations were completed by 1995 a European Community-United States-Japan FTA could be fully implemented by 2005 if it allowed for a 10-year phasein period like the Candian-United States FTA. I notice that is 15 years off. The time between now and the start of the negotiations in 1993 is needed to generate industry support for the proposal, and to make necessary adjustments to our trade balance.

Another criticism of a FTA program is that a major policy shift toward free trade agreements with our major trading partners would undermine the GATT. However, any of the agreements reached on a bilateral basis in an FTA's could lay the groundwork for future advances in the GATT.

Some experts have suggested that the United States-Canadian FTA could be used as a model for GATT reform away from managed mercantilism to true free trade. Furthermore, concerns for the GATT should not stop us from liberalizing trade with our major trading partners.

Moreover, there may be significant advances we could achieve on a bilateral basis that we could never achieve through the GATT because of its size, bureaucracy, diverse interests, and more limited goals. The GATT should never be used as an excuse to slow or impede trade liberalization. But it is, and perhaps FTA's would light a fire under the GATT.

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[2] Hafbauer, Gary. "Beyond GATT," "Foreign Policy." Spring 1990.

World trade would not suffer as a result of a European Community-United States-Japan or OECD FTA. The trade creation effects would be much larger than any possible trade diversion.

In keeping with the GATT, these FTA's could not raise trade barriers to third parties. In fact, the faster economic growth that would result from the increased trade would lead to higher exports from third countries.

In other words, third parties should have nothing to fear from such agreements. In fact, they would probably gain from it without having to make any concessions.

While there is no economic connection between improvements in the trade deficits and completion of an FTA, there is a political one. It may be politically necessary for the United States to make substantial corrections in its trade accounts before FTA negotiations begin.

So long as we are running massive trade deficits it might prove to be politically difficult to make the painful concessions that are required in any economic negotiation. We must act now to bring down our trade deficit which generates so much protectionist sentiment.

Foreign trade barriers are not the cause of our massive trade deficits, and removing them would have little or no effect on them. The primary causes of our trade deficit are our low national saving rate and our Federal budget deficit which cause high real interest rates and a strong dollar.

These problems must be addressed to hold off further protectionist actions, let alone make the liberalizing trade concessions which are likely to be painful for some interest groups. FTA's would not address these fundamental problems, but freer trade would provide substantial gains to our economy and those of our trading partners.

In conclusion, we should act quickly and decisively to correct our trade deficit to pave the way for future trade liberalization measures. The next step should be the conclusion of a free trade agreement with the European Community and Japan, and then other interested parties.

To start the process we should call for a study on the effects of a European Community-United States-Japan FTA and pass legislation granting fast-track approval for such a treaty.

Chairman ROSTENKOWSKI. Thank you.

Mr. Bryant.

STATEMENT OF HON. JOHN BRYANT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. BRYANT. Thank you, Mr. Chairman. I appreciate the opportunity to come and talk to the committee about foreign ownership in America today. I began investigating the matter of foreign investment in the United States in some depth 6 years ago, and reached the conclusion that we did not have adequate data available to us to reliably assess its effects. I also discovered that others—economists, scholars, congressional committees—had over the last decade or more attempted to study foreign investment here and had run up against the same barrier to meaningful research, the lack of reliable and useful information.

I first introduced legislation in the 99th Congress to require the systematic registration and disclosure of information on foreign investment and to require that foreign investment in the United States meet the test of reciprocity—that the foreign investor's home country permit an American to make a like investment on equivalent terms.

According to our best available estimates, in the last 9 years, foreign investment in American farmland, factories, banks, businesses, buildings, Government securities, and other U.S. economic assets has almost quadrupled to more than $1.8 trillion.

We may be paying for the budget and trade policies of the past decade with our economic sovereignty, as authority over vital decisions affecting American jobs, business goals, and prosperity moves overseas. Excessive foreign ownership in our high technology industries could narrow our strategic and competitive edge.

Excessive foreign ownership in our energy and defense-related industries could endanger our national security.

Historically foreign investment has allowed emerging nations, including our own in the 19th century, to develop their economies. But we must remember that we are no longer an emerging nation.

That argument leads us away from the real problem and the fact that we are watching an enormous entry of foreign ownership into our country. The sovereignty of our economic future is at risk. The administration has jumped to the conclusion that foreign ownership is 100-percent good to the extent it has been coming into the country recently. I submit that, without adequate information, we cannot reach a conclusion.

We are unable to understand what is happening. Unlike other nations, we do not require disclosure of basic information on foreign ownership in a form useful for sound analysis or informed decisionmaking.

The Department of Commerce has two sources of data on foreign investment. The first is the Office of Trade and Investment Analysis.

In its publication, you can find a long list of foreign investments by name. This is merely a compilation of newspaper stories and other already published sources which the Department acknowledges is not complete and should not be relied upon. In the front of the book is this disclaimer:

> While every effort was made to verify the information obtained from public sources, the U.S. Department of Commerce is not responsible for any inaccuracies or gaps in information presented in this report.

The Department of Commerce also houses the Bureau of Economic Analysis [BEA], which does systematically collect data on foreign investments in U.S. businesses, under authority of the International Investment Survey Act.

But BEA keeps that data completely secret—even from Congress, which means policymakers can't utilize it as a basis for making public policy and the conclusions based on that data can't be checked by any objective source. Furthermore, BEA does not request the identities of individual ultimate beneficial foreign owners, so they are allowed to hide from BEA behind anonymous dummy corporations.

And even BEA's aggregate statistics are incomplete. The Commerce Department reports a so-called statistical discrepancy in the figures for 1981-87, indicating the agency believes it has completely missed at least $223 billion in foreign capital entering the United States. Other estimates of the ignorance gap are much higher—as much as 100 percent.

There are other acts that relate to foreign investment, but none of them do an adequate job of collecting information; none of them are useful. None of them are organized into a central body of data which can allow us to arrive at any conclusions.

My legislation, H.R. 5, the Foreign Ownership Disclosure Act, would remedy this deficiency in the information available to policymakers. The bill would simply require the systematic registration of information and disclosure to those researchers and policymakers who need information on major foreign-owned interests here.

It would provide the most fundamental kind of information—less information than every publicly held corporation has to disclose to the SEC today.

Access to the information collected would be made available to the policymakers and researchers who most need it. Authorized Commerce Department employees, congressional committees, Congress, General Accounting Office may get it, and an agency in each State may get it. In addition, qualified researchers may apply to the Secretary of Commerce for access.

The energy with which the foreign investment lobby has fought this modest proposal is astounding. The United States would still have the most open foreign investment policy in the world—in stark contrast to the other nations which impose preclearance requirements and all sorts of restrictions on American investors.

Japan, whose multinational corporations and government are vigorously opposing this simple reporting measure, flatly prohibits foreign ownership of more than 50 percent in energy companies or 25 percent in high-technology companies. Several Japanese agencies prescreen each investment in every industry, soliciting comments from Japanese competitors. Based on those comments, the agencies deny or alter investments that they determine "harm the national security, disturb the public order, or hamper public safety," "adversely and seriously affect" Japanese companies, or "adversely affect the smooth operation of the national economy." Any investment could fall victim to these vague requirements.

For many countries, the restrictions are hidden in places one would never suspect. A study has been done by the Congressional Economic Institute which I commend to you for inspection.

Every other country has a mechanism for imposing investment barriers—none of us proposes such barriers in the United States. All we are asking for in this legislation is the collection of information.

I would point out that the need for collection of that data is internationally recognized. In 1984, the Organization for Economic Cooperation and Development, which is composed of the major

Western civilized nations and Japan, promulgated "Declarations and Decisions on International Investment and Multinational Enterprise," a document to which the United States is a signatory. In this document, the OECD called for elimination of discriminatory foreign investment restrictions and adoption of national treatment for foreign-owned companies.

In the same declaration, the OECD called for foreign-owned companies to register and publish the very kind of information that my amendment calls for.

Legitimate foreign investors are here because they see their best investment opportunities here, secure and profitable ones. No simple reporting requirement is going to change those opportunities.

Those that say simple reporting would limit foreign investment in this country are wrong, based not only on experience, but also upon logic. Our current policy of purposeful ignorance about foreign ownership in America handicaps our ability to responsibly manage our own economy.

We can't look clearly at what the results of our economic policies are if we don't outline the extent to which the foreign investment in this country may be changing our future. We can't even figure out what questions we ought to be asking.

I would suggest three questions that I think need to be asked that can only be answered with adequate information. The first question is as follows: Is there a line beyond which it is not in our economic interest to have foreign ownership of a particular industry? Our Energy Department estimates today that 23.5 percent of our domestic refineries are foreign owned, and foreign ownership of our domestic energy industry has tripled in value to more than $33 billion. How much of the rest of the petroleum industry is foreign owned? What are the effects of such purchases on our energy independence?

This can't be answered without additional data.

The second question is: How much foreign influence is taking place in the American political and electoral process.

Since the Federal election law passed in 1974, political action committees [PAC's] formed by foreign-owned or controlled U.S. companies have become commonplace on the American political scene. While the FEC asked Congress for guidance as to whether it intended to allow this practice, in the meantime the FEC is allowing it to continue as long as the PAC's do not take any direction from the parent companies. But presently this is something which the FCC cannot verify.

In 1988, 152 Japanese companies and Government agencies hired 113 firms for representation in Washington. This figure is three times as many as were hired by the British.

The Japanese paid more than $100 million for these lobbying efforts which, according to Pat Choate, an economist and the vice president of TRW, was more than the combined budgets of the U.S. Chamber of Commerce, the National Association of Manufacturers, the Business Roundtable, the Committee for Economic Development, and the American Business Conference, the five most influential business organizations in Washington.

The third question which must be asked is this: When is foreign investment creating jobs and when is it displacing them? When is it increasing opportunities for U.S. business and when is it shutting them out?

In 1987, three House Members asked the General Accounting Office to focus on these very questions in an examination of foreign investment in the U.S. auto and auto parts industries. As their final report notes, the lack of reliable data severely handicapped the efforts of GAO investigators to answer those questions meaningfully. The GAO had to rely on interviews with auto union officials and executives in order to reach a tentative conclusion that foreign investment in these industries may have created as many as 112,000 American jobs or it may have eliminated as many as 45,000 American jobs. In other words, they could not reach a conclusion for lack of information.

I want to make one point before concluding. The Commerce Department and others quite often state as fact that 3 million American jobs have been created by foreign investment. It is very important to understand that this statement is quite misleading.

In short, the Department counts jobs which are already in existence in companies which are taken over by foreign investors as jobs which have been created by foreign investment. That doesn't give us any information about what is really happening to us.

Let me finally say this. I don't think there is any doubt what pressure is going to grow in this country based upon the anecdotal data available to us today that foreign ownership is growing so rapidly.

The pressure is going to grow in this country and this Congress and State legislatures, for efforts to limit in some fashion foreign investment in the way it is done by other countries.

That may or may not be a good idea, but pressure for it is going to be there. I would refer you to a January 1988 speech by Felix Rohatyn, a noted economist and investment banker in this country, who said he had come to question the desirability of complete freedom of foreign investors in view of our growing dependence on money from abroad.

In the January 1988 edition of Forbes magazine, Malcom Forbes called for the immediate creation of a board of knowledgeables whose approval would be required before any foreign purchase of any significance would be allowed in this country.

I am not sure I would go that far, but I am merely trying to point out that the pressure is there. A poll done for the publication, the International Economy indicated 40 percent of Americans want to prohibit foreign ownership entirely; 74 percent believe that foreign investment has lessened U.S. economic independence; and 78 percent favor restricting foreign investment in businesses and real estate. And 89 percent want foreign investors to register with the Government.

The pressure is there, and it is going to continue. It probably will grow. Let's not make public policy in the dark.

Let's pass legislation of some sort—hopefully that which I have introduced or some modification of it—to give us adequate and objective information about foreign ownership in America just as other countries collect about foreign ownership within their borders.

Thank you, Mr. Chairman.

[The statement of Mr. Bryant follows:]

TESTIMONY OF CONGRESSMAN JOHN BRYANT

Before the
House Committee on Ways and Means
Hearings on U.S. Trade Relationships with the Soviet Union
and Eastern Europe, the Implications of "Europe 1992" on American
Direct Investment, and Foreign Investment in the United States

January 24, 1990

Mr. Chairman and members of the Committee, I appreciate the opportunity to speak before you this morning. Six years ago I began investigating the matter of foreign investment in the United States in some depth and reached the conclusion that we did not have adequate data available to us to reliably assess its effects. I also discovered that others--economists, scholars, congressional committees--had over the last decade or more attempted to study foreign investment here and had run up against the same barrier to meaningful research, the lack of reliable and useful information.

I first introduced legislation in the 99th Congress to require the systematic registration and disclosure of information on foreign investment and to require that foreign investment in the United States meet the test of reciprocity--that the foreign investor's home country permit an American to make a like investment on equivalent terms. I am pleased that my reciprocity proposal is enjoying renewed interest as indicated in Secretary Mosbacher's remark during his January 1989 confirmation hearing that we need to "see a two-way street" on investment restrictions. Unlike the United States, which has an unquestioning open door to foreign investment, most other countries restrict or require preclearance of foreign investment.

According to our best available estimates, in the last nine years, foreign investment in American farmland, factories, banks, businesses, buildings, government securities, and other U.S. economic assets has almost quadrupled to more than $1.8 trillion. Foreign money has been financing a record borrowing binge, while disguising the fact that we are living dangerously beyond our means. Floating on a feather bed of foreign financing, the United States has fallen from its status as the world's largest creditor nation in 1982 to become the largest debtor nation in history, with a foreign debt exceeding those of Mexico, Argentina, and Brazil combined.

We may be paying for the irresponsible budget and trade policies of the past decade with our economic sovereignty, as authority over vital decisions affecting American jobs, business goals, and prosperity moves overseas. Excessive foreign ownership in our high technology industries could narrow our strategic and competitive edge. Excessive foreign ownership in our energy and defense-related industries could endanger our national security.

The sheer magnitude of these investments has resulted in increased foreign influence in U.S. economic policymaking and political decisionmaking.

Historically foreign investment has allowed emerging nations, including our own in the 19th century, to develop their economies. But we must remember that we are no longer an emerging nation; we have the mature economy of a world leader. And we may be trading our economic sovereignty for a security blanket of foreign money, not to foster long-term economic growth, but to sustain a high national lifestyle. To finance budget deficits and pay for foreign products, America has been selling off its productive capacity--selling off the family jewels to pay for an eight year night on the town.

This surge of foreign capital, and our growing dependence on it, is the greatest change now taking place in our economy, but one we are ill-equipped to comprehend. Unlike other nations, we do not require disclosure of basic information on foreign ownership in a form useful for sound analysis or informed decision-making.

The Department of Commerce has two sources of data on foreign investment. The first is the Office of Trade and Investment Analysis. In its publication, you can find a long list of foreign investments by name. This is merely a compilation of newspaper stories and other already published sources. In the front of the book is this disclaimer:

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The House Government Operations Subcommittee on Commerce, Consumer and Monetary Affairs, under the late Chairman Rosenthal, concluded that this was an all but useless activity, done primarily for public relations to give the impression of a systematic and reliable collection of data.

The Department of Commerce also houses the Bureau of Economic Analysis (BEA), which does systematically collect data on foreign investments in U.S. businesses, under authority of the "International Investment Survey Act." But BEA keeps that data completely secret--even from Congress--and publishes only aggregate statistics which are of no use to analysts. Furthermore, BEA does not request the identities of individual ultimate foreign owners, so they are allowed to hide from BEA behind anonymous dummy corporations.

And even BEA's aggregate statistics are incomplete. The Commerce Department reports a so-called "statistical discrepancy" in the figures for 1981-1987, indicating the agency believes it has completely missed at least $223 billion in foreign capital entering the United States. Other estimates of the ignorance gap are much higher--as much as 100 percent.

The "Agricultural Foreign Investment Disclosure Act" also invites anonymity. The Agriculture Department lists 270,000 acres of Texas agricultural land owned by residents of the Netherland Antilles--one acre for every man, woman, and child who lives there. In all likelihood, none owns even one square inch, because the registered landowners are, in fact, dummy corporations.

My legislation, H.R. 5, "The Foreign Ownership Disclosure Act," would remedy this deficiency in the information available to policymakers. The bill would simply require the systematic registration and disclosure to those researchers and policymakers who need the information on major foreign-owned interests here.

There are two separate thresholds, with different reporting requirements. The first threshold is for interests of more than five percent in a U.S. business or real estate holding valued at more than $5 million dollars. For this threshold, which applies to the vast majority of interests covered by the bill, the bill asks only: "who are you, where are you from, what threshold interest do you hold, and what is the value of the U.S. economic asset in which you hold the interest?"--information that would fit on a postcard.

The second threshold is for controlling interests over 25 percent in a U.S. business with assets or annual sales exceeding $20 million. For this threshold, the bill asks for basic financial data, less than what publicly traded American corporations--even of much smaller size--already disclose to the Securities and Exchange Commission.

Access to the information collected, would be made available to the policymakers and researchers who most need it. Authorized Commerce Department employees, congressional committees, Congress, General Accounting Office may get it, and an agency in each state may get it. In addition, qualified researchers may apply to the Secretary of Commerce for access.

The energy with which the foreign investment lobby has fought this modest proposal is astounding. They have consistently attempted to characterize my proposal as some onerous restriction that would inhibit foreign investment here. But the truth is quite the opposite. As anyone who has read the proposal knows, it creates no restrictions at all. It requires no preclearance at all. It simply asks major foreign investors to sign in after they have walked through our open door. The U.S. would still have the most open foreign investment policy in the world--in stark contrast to the other nations which impose preclearance requirements and all sorts of restrictions on American investors.

Japan, whose multinational corporations and government are vigorously opposing this simple reporting measure, flatly prohibits foreign ownership of more than 50 percent in energy companies or 25 percent in high-tech companies. Several Japanese agencies pre-screen each investment in every industry, soliciting comments from Japanese competitors; based on those comments, the agencies deny or alter investments that they determine "harm the national security, disturb the public order, or hamper public safety," "adversely and seriously affect" Japanese companies, or "adversely affect the smooth operation of the national economy." Any investment could fall victim to these vague requirements.

The other major industrial countries also have restrictive policies. In fact, investment restrictions are the norm; our complete openness is the exception. Even England's and Switzerland's policies are much more restrictive than ours.

For many countries, the restrictions are hidden in places you would never suspect. A Commerce Department official advised my office that the only way for American investors to find out about the investment restrictions in a particular European country--whose ambassador to the United States has personally lobbied against my proposal--was to "hire a lawyer, try to make the investment, and see what they run up against."

Simple reporting, such as my bill would require is not a restriction at all, as some would have you believe; quite the contrary, it is internationally recognized as a completely different animal by the Organization for Economic Cooperation and Development, composed of the major Western industrialized nations and Japan. In the 1984 "Declaration and Decisions on International Investment and Multinational Enterprises"--to which the United States is a signatory--the OECD called for elimination of discriminatory foreign investment restrictions and adoption of national treatment for foreign-owned companies. In the same declaration, the OECD called for foreign-owned companies to register and publish the very kind of information that my amendment calls for. In other words, the United States government has agreed in the international community--as has Japan and the countries of Western Europe--to the very disclosure that first the Reagan Administration and now the Bush Administration so vigorously opposes.

Legitimate foreign investors are here because they see their best investment opportunities here--secure and profitable ones. No simple reporting requirement is going to change those opportunities.

Foreign investors place their assets in the U.S. because it is a politically stable environment. Investors have access to a skilled workforce and the latest research and development efforts. They hedge their bets against future protectionist trade barriers by establishing production facilities in the United States. Why would simple disclosure stop them from investing here, if much more onerous requirements have not stopped them and Americans from investing abroad?

Our current policy of ignorance handicaps our ability to responsibly manage our own economy. We don't have enough information to even know most of the questions we should be asking, but I will venture to suggest a few I believe we ought to be equipped to answer.

FIRST QUESTION: Is there a line beyond which it is not in our economic interest to have foreign ownership of a particular industry? Does foreign control in that industry beyond some point begin to endanger our national security?

Already the Energy Department estimates that 23.5 percent of our domestic refineries are foreign owned and that foreign ownership of our domestic energy industry has tripled to more than $33 billion worth in the past eight years. How much of the rest of our petroleum industry is foreign-owned? What are the effects of such purchases on our energy independence? We can't assess these questions with currently available data.

SECOND QUESTION: How much foreign influence is taking place in the American political electoral process? How do we guard against the funneling of campaign contributions into U.S. political campaigns anonymously from abroad, as we know happened during President Nixon's 1972 reelection campaign?

Congress amended the Federal Election law to stop that practice in 1974. Thomas Harris, Commissioner on the Federal Elections Commission from 1976-1986, who also served as its chairman, is a vocal opponent of the practice that has developed since the 1974 act of foreign-owned or controlled U.S. companies forming political action campaigns. While the FEC has asked Congress for guidance as to whether it intended to allow this practice, in the meantime the FEC is allowing it to continue, as long as the PACs do not take any direction from the parent companies or any other sources. But Ex-commissioner Harris says that it is not currently possible for the FEC to determine whether the PACs are taking direction from abroad, because it is impossible even to determine which U.S. companies with PACs are foreign owned.

In 1984, out of fear that foreign investors would take their funds elsewhere, the Reagan Administration pressed Congress into repealing the 30 percent withholding tax on earnings on foreign-held government and corporate securities. Japanese interests have hired more than 110 former government officials and enlisted the aid of American businesses dependent on Japanese companies to influence Congress and the White House. In 1988, Toshiba Corporation and its U.S. subsidiary, Toshiba America, launched a successful $9 million campaign to persuade Congress to drastically ease the sanctions against Toshiba for is sale of sensitive advanced submarine technology to the Soviet Union.

THIRD QUESTION: When is foreign investment creating jobs and when is it displacing them? When is it increasing opportunities for U.S. businesses and when is it shutting them out?

In 1987, three House Members asked the General Accounting Office to focus on these very questions in an examination of foreign investment in the U.S. auto and auto parts industries. As the final report notes, the lack of reliable data severely handicapped the efforts of GAO investigators to answer these questions meaningfully. GAO had to rely on interviews with auto union officials and auto executives for its tentative conclusion--that foreign investment in the U.S. auto and auto parts industries may have created as many as 112,000 American jobs, or it may have eliminated as many as 45,000.

Opponents of my legislation always claim that a Commerce Department statistic indicates that foreign investment in the U.S. has created 3 million American jobs. This claim is highly misleading, and I would like to take a minute to explain why.

What the Commerce Department statistic really indicates is that foreign-owned companies which file reports with the Bureau of Economic Analysis say they employ a total of 3 million workers in this country. But some of these workers are foreign employees brought over from the foreign owner's home country.

In addition, this statistic does not indicate how many jobs the foreign owners have created, but how many employees he has. There is a big difference. Let's say, for example, that a foreign company takes over a U.S. company that employs 20 thousand workers. After the takeover, the new foreign owner fires 10 thousand of those workers. It moves 9000 of those jobs overseas, and brings in 1000 workers from the foreign home office. Ten thousand Americans have lost their jobs, but the Commerce Department would say that the foreign worker has "created" 11 thousand American jobs--the ten thousand Americans who kept their jobs and, and the one thousand foreign workers now employed in the U.S.

This is exactly what happened when Campeau, a Canadian investor, took over Allied and Federated Stores. Thousands of American workers lost their jobs, but the Commerce Department scored it as a creation of thousands of U.S. jobs by a foreign investor.

With 3 million American workers now dependent on foreign companies for their livelihood, don't we have a right to some basic information about those companies.

Opponents of my proposal are, in effect, arguing that our growing dependence on foreign financial assistance compels us to remain ignorant about it. They try to characterize the debate over my proposal as about whether foreign investment is good or bad or whether it should be restricted or not. This is a much easier debate for them than the real debate, which is whether we can responsibly choose to remain in the dark as public concern continues to mount and as people, including some prominent Americans, begin questioning the merits of undisclosed foreign investment here.

In a January 1988 speech to the Economic Club of Washington, New York investment banker Felix Rohatyn said he had come to question the desirability of complete freedom for foreign investors in view of "our growing dependence" on money from abroad. In the January 25, 1988 issue of Forbes Magazine, Malcolm Forbes called for the immediate creation of a "Board of Knowledgeables whose approval would be required before any foreign purchase of any significance would be allowed of any consequential U.S. company--regardless of size." Most recently, in the July 10, 1989 issue of the magazine, Mr. Forbes concludes that the government does not currently collect adequate data to determine who outside the United States owns what in the United States. He goes on to urge Congress to swiftly pass a bill to require basic foreign ownership reporting.

America is now hundreds of billions of dollars in debt internationally, with predictions that we may be more than a trillion dollars in debt by the early 1990's. In the coming years, Congress will increasingly hear emotional appeals to restrict foreign investment from people who fear it or oppose it. A 1988 opinion survey for The International Economy indicated that 74 percent of Americans believe foreign investment has lessened U.S. economic independence, 78 percent favor a law restricting foreign investment of businesses and real estate, and 89 percent want foreign investors to register with the government. We will hear other emotional appeals to promote and subsidize foreign investment from people who are desperate for financial assistance.

The pressure for Congressional action will increase continually. If Congress is not equipped to make sound policy judgments based on reliable information, we will be left at the mercy of textbook theory, anecdote, and emotionalism and U.S. interests will not be preserved.

It would be highly irresponsible of us to consciously remain in the dark as public concern continues to mount. We need reliable information, and we need to get it into the hands of the numerous researchers inside and outside of government on which Congress relies for the analytical base on which to make responsible public policy.

Chairman ROSTENKOWSKI. Mr. Campbell.

STATEMENT OF HON. TOM CAMPBELL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. CAMPBELL. Today I testify against obstacles to American investment overseas. The reason I do is because we have three components of our trade deficit: trade in goods, trade in services, and the flows from investment. The trade in goods is running about $126 billion in deficit. The trade in services is running about $20 billion surplus.

In 1988, for the first time in postwar history more of America was owned by foreign concerns than Americans owned of foreign assets. The rate of return on those investments in America was higher for foreigners than Americans received on their investments overseas. Thus, the trade account turned negative in the third component: flows from investment. That is why I am testifying today.

When you have a problem of trade-flow, you have to do two things. My colleagues this morning, I think, pointed them out. First, correct the mistakes in your own house. There is no question about that. We need to improve the American savings rate, improve American investment, improve American productivity. Make it easier for Americans to invest in America. That is the first step.

The second thing we always do is to say are there unfairnesses in our ability to invest overseas? Just as we said in the trade in goods area, are there unfairnesses in our ability to sell overseas? So, here are there unfairness, in our ability to invest overseas? I think the question before us today is not should we restrict foreign investment in the United States, but should we receive the same treatment when we go overseas that we accord to foreign investors when they come here. If we don't, if we continue a one-way street, this third component of our trade deficit will only grow more negative.

I submit we are in no position to have any component of that trade deficit grow. The first suggestion would be why not handle this through the GATT that served us so well since 1947? There is a very good answer why not. Simply, GATT does not deal with investment. We tried at the very start of negotiations to see if we could get an international code on investment. We failed, and GATT was restricted to trade in goods.

So nothing that I suggest today violates GATT. But how about the spirit of GATT? You hear an awful lot about not violating the spirit of GATT. Let me speak about the spirit of GATT. In 1947, when GATT was adopted, the United States was the only economy on its feet in the world. We made concessions in the context of the trade in goods in order to allow those countries devastated after World War II to rebuild their economies.

The principal concession we made was the rule of most-favored nations, adopted instead of a rule of reciprocity. The rule of most-favored nations says, "Foreign countries, you can keep your higher tariffs. America will keep its lower tariffs so long as both of us come down together." America was willing to do that fundamentally to help restore trade throughout the world.

If America kept its tariffs high instead, there very well may never have been a restoration of industry in postwar Europe. Well, that is one very big difference between the trade in investment situation we have today and the trade in goods we had at the end of World War II.

I submit America is in no position today to say we will bear the brunt of a most-favored nations rule, that says, "You can continue your higher barriers against us than we have against you so long as we all agree to come down."

There is a second distinction. In point of fact we have not agreed to come down on the barriers on investment even though we did agree on trade in goods. So the distinctions between the most-favored-nations rule for goods and the rule of reciprocity on investment is, I think, very well founded.

All the same, wouldn't it be wiser if we didn't act unilaterally? I suspect you will hear this argument a lot. Maybe it is time to deal with foreign investment, but why not through the multilateral trade context? Again there is a major difference to bear in mind. Europe 1992, the topic this committee will be listening to in later testimony, is a substantial break from the understanding of the GATT.

Yes, GATT did anticipate free-trade zones. That was part of the original GATT understanding. You will find permission for free-trade zones in GATT. But nobody in 1947 anticipated an entire Europe as a free-trade zone with no internal barriers to trade in goods or trade in investment. I submit to you that Europe in adopting that free-trade zone acted unilaterally. As a result, Europe 1992 will will see lowered investment barriers as to Europeans investing in other European nations, but investment barriers kept high as to the United States.

I would surely prefer a rule of reciprocity to be adopted in investment after multilateral negotiations rather than unilaterally. But, Mr. Chairman, do we really expect that to come out of the present Uruguay round? That round is in its last year. By recent history, it will be 10 years before another GATT trade round is completed.

I would prefer it to be the process of multilateral negotiations, but no one, I think, can look you in the eye and say that is likely to happen.

The last argument is that our foreign investor colleagues might not like what we are doing and might retaliate. Let's consider exactly what that argument means.

First of all, no country I know of has a barrier to another country's citizens investing in their bonds. To the extent our massive trade deficit and budget deficit is being financed by foreign investors buying our bonds, that won't be touched at all by a reciprocity rule. But it might be that foreign investors or perhaps their countries would say, well, America is getting tough. America is playing by a two-way street instead of a one-way street. We are going to retaliate by withdrawing our investment from the United States.

Highly, highly unlikely. Why should they withdraw? Their investment in the United States is extremely profitable. All my bill will do would be to say to our U.S. Trade Representative, under the authority she already has under 301, to find an unfair trading practice in the fact that we cannot invest as much overseas, as readily overseas, with as few restrictions overseas, as foreigners can invest here. We would present to our trading partners a two-way street so that they might open up opportunities for us to invest overseas so that that third component of trade may turn positive.

If, as a result, our trading partners say, "America is getting tough," I think that would be precisely the right message.

Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Thank you, Mr. Campbell. Are there any questions of our colleagues? I want to thank you for joining us this morning. You have been most informative and cooperative. Thank you very much.

Mr. **Frenzel**. Mr. Chairman, I have a question. I would first like to thank all the panelists, particularly the noncommittee panelists for coming up and helping us with these difficult subjects.

I would like to address a question to Representative Campbell. It is that this bill, as I understand it, provides that you, once an investment practice is designated as an unfair practice, the U.S. Trade Representative must retaliate under a mandatory provision. Is that correct?

Mr. **Campbell**. That is correct.

Mr. **Frenzel**. Yet, you told us this bill was going to be GATT legal, but, as you know, investment is not covered under the GATT. And to declare it an unfair trade practice is a unilateral act by the United States which disregards our obligations under the treaty. And not only can we retaliate, under your bill we are forced to retaliate, which means we are, therefore, in violation of the treaty that we have signed.

Does that serve you at all?

Mr. **Campbell**. No, sir, but it is not accurate. Investment is not covered by the GATT. The obligation under GATT not to act unilaterally extends only to the topics covered by the GATT. So that if a subject is not covered by GATT, to act in a unilateral fashion——

Mr. **Frenzel**. Let me ask you again. Under your bill, the U.S. Trade Representative is authorized and in fact mandated to take a variety of remedies, some of which are trade remedies.

They have nothing to do with investment. You are in the same—we are getting into the same arguments that we have been in all along. We are declaring, as we did in the Trade Act of 1988, we in the United States declare somebody's actions to be an unfair trade practice.

But, the international law or the international treaty, the general agreement on tariffs and trade, do not declare those practices to be illegal. Therefore, we take action. Then the aggrieved party against whom we have taken action takes us to the GATT, and we lose.

Mr. **Campbell**. My good friend and senior colleague, you are mistaken in your understanding of my bill. The mandate upon the U.S. Trade Representative is in the investment area only. My purpose is to reciprocate in like kind. It is not to give to Ambassador Hills—in our instance, presently—the right to impose tariffs on automobiles because we can't invest in banks. It is precisely to propose that we have barriers on investment in banks if we can't invest in banks.

So I am quite confident that my bill meets your challenge, sir.

Mr. **Frenzel**. Well, perhaps I do not understand your bill. Certainly I didn't understand your reason for introducing it.

My problem, it looks as though the U.S. Trade Representative has all the authorities of that section available to her, and she is in fact mandated to use them, some of them. Therefore, she would be mandated to use, if she deemed it proper, a trade-related remedy.

Mr. **Campbell**. Again, sir, that is not the language or intent of the bill. Indeed, to be reciprocal is precisely the purpose here, which breaks away from the more general approach in section 301.

Now, you identified 301 as giving the U.S. Trade Representative broader authority to respond. Perhaps that is the point of confusion. Yes, it is true, for example, in response to America not being able to sell chips to Japan, under 301 the U.S. Trade Representative imposed offsetting duties on electronic goods.

The two are not the same. Perhaps the confusion is that I referred to 301 in my testimony. My bill is narrow. It would give the U.S. Trade Representative only authority to reciprocate in that kind.

So, I am dealing with investment remedies to investment problems.

Mr. **Frenzel**. I think there is a problem, and I will be glad to discuss it with you later. The thing that causes a problem is I think you got your bill in the wrong place.

Most restrictions on foreign investment are restrictions as Exon/Florio, where the discretion is given to the Secretary of the Treasury who theoretically knows something about investment and is supposed to do it.

For reasons of your own, you have given an agency which I am not sure is wholly competent to make those decisions because you thought it fit here, to make those decisions. It looks to me like she is carrying some other baggage along with it with respect to authority that I think needs to be looked at further.

I thank the gentleman for trying to straighten out my confusion.

The intent of the gentleman in writing the law is that the United States will immediately respond with mirror legislation or directive, I guess, because you conferred that authority, so that she can now write law, to create by a mirror directive exactly the same restriction on investment that she encounters abroad. Is that your intention?

Mr. **Campbell**. It is my intent, but as close as reasonable. That is why I, in my draft, gave the authority to the U.S. Trade Representative rather than to the Secretary of the Treasury because the U.S. Trade Representative is adept and practiced at precisely this concept of getting us as close as possible.

I suspect it cannot be a perfect mirror in many cases. I would be happy to defer to the good faith of the U.S. Trade Representative in making the effort.

Mr. **Frenzel**. Mr. Chairman, may I inquire further and ask the gentleman if he is aware of some of the other mirror legislation that we have enacted such as that against Canadian border broadcasting restrictions and the results to the United States economy that flowed from that episode?

Mr. **Campbell**. Yes, I am familiar with it. That was one of the subjects I used to teach in U.S. trade as an example of a bad approach.

It was to allow flexibility other than an exact mirror that my legislation gives to a Cabinet officer with discretion and sophistication but in the direction that it be in the general nature of reciprocal.

Mr. **Frenzel**. You don't trust the Congress to do it?

Mr. **Campbell**. I think it is difficult for Congress to pass a precise mirror legislation that completely offsets. Suppose one particular investment was a small percentage of Canadian investment in America. Yet that same kind of investment was a large percentage of American investment in Canada.

An exact offset might not be a fair way of dealing with the problem.

Mr. **Frenzel**. Your bill does not take into account any restrictions that the United States has against foreign investment?

Mr. **Campbell**. I am glad you raised that. You might recall my opening testimony, I said at the very start America has to clean its own act up as well. I would strongly favor ending trade barriers of all kinds on investment and on trade in goods in the United States with which our economy is sadly replete.

Mr. **Frenzel**. You are aware we are defending ourselves against the Europeans' interpretation of their banking directive with respect to specific reciprocity, and we will table on Monday an investment planning which we hope will become a part of the Uruguay round.

Mr. **Campbell**. From your lips to God's ears, if Mrs. Hills obtains reciprocity investment in the Uruguay round, she deserves a Nobel Prize.

Mr. **Gibbons** [presiding]. The chairman says your 5 minutes is over.

Mr. Pickle.

Mr. **Pickle**. Thank you, Mr. Chairman. I would like to ask Mr. Bryant if the administration had taken a position on your legislation.

Mr. **Bryant**. Well, I don't know if they have this year, but they have opposed it in the past. I am sure that they probably would again.

Mr. **Pickle**. Mr. Gradison, has the administration taken a position on either your trade zones or your reciprocity approach?

Mr. **Gradison**. Mr. Pickle, it's been some months since I have discussed this with Ambassador Hills. What she said to me at the time, perhaps 6 months ago, was that she thought that the idea was premature.

I would only respond very briefly that year 1992 is getting closer and closer, and I would hope that what might have seemed premature 6 months ago would not seem premature today.

So I don't know what the current view of the administration would be one way or the other.

Mr. **Pickle**. Mr. Campbell.

Mr. **Campbell**. There is no official administration position of which I am aware, but I did speak with Mrs. Hills, and she did convey to me her opposition to my bill, at least in the informal context of our conversation.

Mr. **Pickle**. Mr. Chairman, I do not see that the administration is scheduled to testify on this very widely important subject. It would seem to me like we should have a sponsor for the administration from the Secretary of Commerce, Secretary of State, or the Special Trade Representative as we go forward in these hearings. It's extremely important.

Each of us may have our own ideas, but if we make any advancements in this very complex problem, we ought to have a statement.

I would hope someone is hearing, Mr. Chairman, and we could schedule these Cabinet people or someone to tell us what the administration's position is.

Mr. **Gibbons**. Mr. Pickle, we tried to get them to come here today, but they have got paralysis because they haven't had a chance to deliver their State of the Union Message. When they get that out of the way, the paralysis will begin to unwind, and they plan to send representatives to appear before us.

You are absolutely right in your position.

Mr. **Pickle**. Thank you, Mr. Chairman.

Mr. **Gibbons**. Mr. Pease is next, and then you.

Mr. **Pease**. Thank you very much, Mr. Chairman.

I would like to thank our colleagues for, I think, a very, very well prepared testimony. One need not agree with every aspect of it to be impressed with the lot of work and scholarship that went into the work and testimony.

I would like to begin by congratulating Mr. Campbell for his courage in coming before the committee and suggesting that the gentleman from Minnesota be deficient in his understanding of the GATT.

I would like to ask a question or two of my colleague from Ohio, Mr. Gradison. Just to put a time line in respect to the bill, I am thinking in particular of your idea for a free-trade arrangement with Japan.

As you know, our problems in Japan are promulgating into the Japanese market with American products, but relate very little to tariffs in other obvious barriers, but rather more to the Japanese distribution system, to the interlocking relationship of banks and industry and distribution change and so on.

And I guess I am a little concerned that that sort of thing might not be resolved, or at least resolved completely in any negotiation for free-trade arrangement, and that to go ahead and enter into a free-trade arrangement when we get rid of all of our barriers would leave them with their informal barriers, and us with none at all, in light of the fact that our trade deficit with Japan is well into $50 billion a year.

I think you did mention that you thought we ought not to start negotiations until we began to address these trade imbalances. Did you specifically have in mind putting off negotiation with the Japanese until the $50 billion deficit has begun to come down?

Mr. **Gradison**. Well, frankly, I would not support a free-trade agreement that was just limited to tariffs, nor, by the way, is there one which this committee approved and the Congress approved in Canada.

One of the questions that was examined with care were the Canadian restrictions on direct investment by U.S. firms. And we spent quite a bit of time on that, and they made major concessions along those lines.

We have never been able to reach that issue through the GATT process, and in that sense, the FTA approach gives us a means of reaching some of the questions which my colleague from Ohio is concerned about and which I am concerned about as well.

I would say personally, I think the highest priority should be given to moving first toward the beginning of a free-trade agreement negotiation with the European community.

I think there is a growing fear outside of the EC that as they open markets among themselves and remove trade barriers gradually within the EC that some walls may be built around that group, making it more difficult for major trading countries, such as the United States and Japan for that matter, to penetrate the European markets. I think we should anticipate that possibility.

Now, frankly, I sense that quite a few American companies, recognizing that uncertainty and seeing that we put all of our cards—all of our chips on the GATT and are not exploring a broader trade agreement with the EC, are moving, perhaps, a lot quicker than they would otherwise to build their own manufacturing facility in Western Europe to assure themselves of access to that largest market in the world, largest market without barriers in the world, larger than our own investing department.

So if only from a job front and that is not—it's a very important consideration, but not the only one, just from a job point of view, I think it's in our interests to at least signal we want to start thinking and working with the EC toward an FTA so as to send a signal on our own businesses, hey, we see a way for you to maintain access to those markets that you have today without having to move the factories over there.

Mr. Pease. Well, I think my colleagues count it as very appropriate in relation to Europe. My concern is more with Japan than Europe. As my colleague knows, during the last couple of years with the dollar getting weaker, our very substantial trade deficit with Europe has turned into a surplus or a near surplus. That has not been the case with Japan.

Despite the fact that the dollar is worth a lot more now than it was a couple of years ago, our deficit with Japan has gone down only very marginally, and I am just curious as to whether the gentleman in the case of Japan would want to see a significant reduction in that deficit before we enter into a free trade arrangement negotiation.

Mr. Gradison. Of course I would, yes.

Mr. Schulze. Thank you, Mr. Chairman.

Very briefly, I would like to thank our colleague, Mr. Gradison, and I agree with him wholeheartedly on bilaterals. It's been my position for a long time, and I think it's an extremely valuable tool and one that perhaps we have overlooked, and we should utilize more fully. And I thank you for reiterating that.

To our colleague, Mr. Campbell, Tom, one of the problems is you cannot use the word "reciprocity." Reciprocity means protectionism in the great world of semantics; and as it goes around the world, your bill is automatically protected, if you use the word "reciprocity."

I have coined the phrase "symmetrical access." I think that if you use symmetrical access, you may find a little more acceptance to your proposal, and I think it does have merit, and I appreciate your putting it forth.

But do other nations around the world have legislation which requires symmetrical access?

Mr. CAMPBELL. Yes, they do. I am just trying my new-found phrase. Symmetrical access finds an appearance in the trade laws of many countries. Indeed, in preparation of my testimony, I went through the document, the 1989 National Trade Estimate Report on Foreign Trade Barriers, prepared by the U.S. Trade Representative; and you will see several countries, particularly the one I just turned to, France, that does have symmetrical access.

Mr. SCHULZE. I would suggest that he look into it further and that I wish him well with his proposal.

I thank our colleague from Texas for his testimony.

Mr. GIBBONS. Mr. Guarini.

Mr. GUARINI. I want to thank each and every one of you for your very thoughtful and excellent testimony.

I voted for your bill, and I agree that we should track the amount and extent of foreign investment in the United States.

But I just wondered, what good is it going to do us? Suppose we do find that most oil refinement is done outside the country? Is it going to affect our independent, central policy?

Bill Gradison said we should have free trade agreements where we are going to be without any kind of a trade restriction whatsoever. So if we do find that we are not competitive and the other countries are investing heavily in the United States, what good will it be to have all this information?

Mr. BRYANT. First of all, it would tell us the results of our existing economic and trade policies.

Mr. GUARINI. I agree with that. What are we going to do with it all and how can we put it into action if we are not going to have any barriers between countries and we are going to have free-trade agreements? That is the direction of the world tomorrow.

Mr. BRYANT. Reciprocity was taken out of the bill. I believe that if we are indeed losing our control of our economic future, we should adopt measures to regain control. These measures would probably prove some type of incentive for domestic ownership in certain areas.

Mr. GUARINI. Are we going to have independent, central policy dictated by statistics and what happens?

Mr. BRYANT. Well, I think we will have policy dictated by the statistics. I don't know if we would have independent, central policy; but maybe we would. But I think it's obvious that it would take some kind of an action if indeed we were losing control of our economic future, but right now we don't know that.

And I think it's totally preposterous for us to continue, as a conscious policy—as the administration would urge us to do—to remain in the dark on purpose.

Mr. GUARINI. Well, I do hope we find some answer, because I think it's a very troublesome question, and what Tom Campbell is referring to is cases where investment is unfair. To that extent, you are not talking about the quantity of investments but perhaps the type or quality of investments, and that makes infinite sense to me, also.

Bill, in regard to free-trade agreements, you know, we cannot even get agriculture on line at GATT because of Europe, and we will never get into the rice patties of Japan, et cetera.

In discussing this free-trade agreement situation with Salinas, the President of Mexico, where there are economies of vast differences, he did suggest that there be sector free-trade agreements, not a free-trade agreement in its totality, but certain kinds of manufacturing sectors or things that we could agree on.

Do you think that that could be, or have you given any thought, of a way of the first stage of having free-trade agreements with Europe or with Japan where we might cover aerospace, or computer chips, or telecommunication, or in some particular sector, steel, and type of industrial output?

Mr. GRADISON. Well, as a general principle, I would prefer not to do that, and we didn't do that in the Israeli case or the Canadian case. What we did was identify with most import-sensitive industries and provided a much longer timeframe for the phasing out of the existing restrictions on both sides, as you know, extending as long as 10 years in some cases.

I think that is a better way to go. I would acknowledge completely what I understand to be—what I infer from what you have asked, and that is that it makes a lot more sense to explore this with Canada, or Israel, or the EC, or for that matter with Japan, because there is sufficient similarities in the development of the economy that we might be talking about apples and apples, or oranges and oranges.

To discuss this at this time with Mexico would just not fit the circumstances of development of and the economies of the two——

Mr. GUARINI. They are too vastly different.

Mr. GRADISON. Yes, indeed. I don't see the free-trade agreement is the answer to all of our problems, and maybe I am impatient with the GATT process unreasonably. But if you think we got slow moving bureaucracies in the United States, spend a couple of days in Geneva. It's a real eye opener.

Mr. GUARINI. Well, I think there is no question that your vision of the future is one that we all share. It's just a question of how we get there.

Thank you.

Mr. GIBBONS. Thank you.

Mr. Levin.

Mr. LEVIN. Thank you for your excellent testimony.

Two quickies.

First to John. Under the act and the collection of data by the BEA, is it clear, is there a requirement that the data be kept secret?

Mr. BRYANT. There is.

Mr. LEVIN. So that there is no way that they could disclose that. We could amend that act to provide for its publication.

Mr. BRYANT. We could, but it would not be a substantial help to us unless we also amend it to require thorough disclosure, including disclosure of the ultimate beneficial owner; that is to say, disclosure of the person who is really in control of the investment.

And at the present time, that is not done.

Mr. **Levin**. Second, to my good friend and my colleagues in the Ways and Means Committee, let me rephrase or reinforce, if I might, the question in point of Don Pease by asking you whether you think a free-trade agreement with Japan would likely do anything to affect the imbalance?

Mr. **Gradison**. No, I don't. I don't. I think that the—I think one of the great virtues of moving along these lines would be to strip away the veil, if you will, to show that there are factors that affect trade balance between particular countries which are not easily explained by some of the things which we look to.

And I think that might be very helpful in terms of the development of public policy on this issue. I think there are important barriers to United States investment and United States penetration or in Japanese markets. I have no question about that.

But it's also fair to say that we have some important barriers to U.S. markets for Japanese products. Automobiles are a very good example. It's a very major barrier.

My hunch, it's nothing more than that, but it's an informed hunch, is that if both sides of the barriers were stripped away, there wouldn't be a substantial difference.

Mr. **Levin**. There would not be.

Mr. **Gradison**. Not in my judgment. I tell you, it's an excellent question, and I hope frankly that you will have an opportunity to pursue that with people who have a more detailed knowledge of this than I do.

But that is my conclusion from thinking about it and reading the literature.

Mr. **Levin**. Two quick things.

Mr. **Gradison**. I think that there is a very unfortunate tendency in discussions of trade to focus solely on the very damaging impediments to trade imposed by our trading partners without also at the same time taking a look at those which we impose ourselves.

This is not to say we are the bad guys and they are the good guys, but we are all involved in this, and there are major sectors of our economy, starting with steel and automobiles and agricultural produces and the list is long, which we oppose of barriers.

That is fine, that is a decision which we made, but I think we must recognize that if we go in and negate, ask our trading partners to negate away restrictions, we had best be willing to negate some of our own, or we are not going to get anywhere.

Mr. **Levin**. Two quick points.

First of all, it seems to me that the record is pretty clear, regardless of the impediments, and we have some in this country. There is no close case between Japan and the United States in terms of barriers. If you ask American business people about the barriers that have been created by companies, Japanese companies here in terms of selling to them, they will tell you that.

These joint ventures in this country did not arise out of volition in terms of doing business with transplants.

But second, I am not suggesting that the trade imbalance is a reflection only of practices of other countries. I think a lot has to do with the failure of policy and practices within this country, but I do think there is an issue of priority in terms of emphasis on free trade agreements or emphasis on reduction of the trade imbalance.

And if free-trade agreements will have little to do or nothing to do with correction of the trade imbalance, either in terms of the practices of other countries or our own policies or lack of them, we need to, I think, make some hard decisions where we put our emphasis in the next few years.

And in my judgment, I think this country had better begin to worry much more creatively about the trade imbalance and its implications both in terms of the practices of other countries and our own failings.

And in that sense, your testimony kind of helps shape the issue. Where is our priority? Where are our emphases these next few years?

Mr. GRADISON. I don't think we are going to substantially reduce the trade imbalance so long as we continue to run fiscal deficits to the extent that we have been running them and to the extent that our savings rate stays as low as it has.

So as long as we are in a world of flexible floating exchange rates, it's all going to balance out one way or the other. I mean, just look at what has happened recently where there is some report that our long-term Government bond rates don't seem quite attractive enough to certain foreign investors, the rates go up. It balances a shift.

But so long as we have that kind of a world where interest rates can change and capital responds to those changes of rates, I think that we are aiming at the wrong target if we think that we can deal with the bulk of the problem, other than through fiscal means.

I am not saying that that isn't a part of it, but my guess is 75 to 80 percent of the trade balance probably can be explained by problems in our fiscal savings deficit.

Mr. LEVIN. I agree with you.

Mr. GRADISON. I am not saying not to work on the 20 or 25 percent, but I don't think we ought to get off the ball.

Mr. CAMPBELL. Mr. Levin, can I respond as long as we can sneak it in, that I wish to correct the record. At page 108, the U.S. Trade Representative cites Japan, not France, as an example of symmetrical access. I apologize to France and to Mr. Schulze and the committee.

Thank you.

Mr. CARDIN. First I want to thank all three of my colleagues for their contribution in this very important area. I think most of us share the frustration that John Bryant has expressed as we are called upon to take action without knowing exactly what the facts are.

We see a lot of conflicting figures that are out there, and it would be extremely helpful to have the information before we are called upon to make policy decisions.

Tom, I wanted to ask you about your bill. Under your bill, if a nation had a law such as Congressman Bryant is suggesting on disclosure, would that fall under the type of act, policy, or practice of a foreign country that would force the United States to take reciprocal action here?

Mr. CAMPBELL. Yes, it would.

Mr. CARDIN. So you would want to cover disclosure laws in addition to it?

Mr. CAMPBELL. Yes. Sometimes outcomes in takeover battles are determined by very close time periods, and disclosure laws against one party not imposed on another would affect the outcome.

Mr. CARDIN. How would you expect the U.S. Trade Representative to act if a foreign country uses information in its relationship with the business community and perhaps works with its regulators on discretionary regulatory action that in effect discriminates against U.S. investment in that country but is not a defined law?

How would you anticipate like action by our country?

Mr. CAMPBELL. It's a very thoughtful question. It's for that reason that instead of setting an absolute, strict rule, I gave discretion to the U.S. Trade Representative. I think it's an appropriate area for administrative discretion.

If such information is being misused in the manner you suggest over a period of instances, then I think it's appropriate for us to act. If, however, it's an occasional administrative misuse which is not indicative of a policy, I expect our U.S. Trade Representative would not act, and it seems to me that is the right sort of discretion to give.

Mr. CARDIN. But if the Trade Representative is going to act and we are talking about discretionary, administrative practices of a particular country, wouldn't then we be getting into the types of actions that Congressman Frenzel was referring to that would normally come under GATT?

Mr. CAMPBELL. No, because it would still be relative to investment. It would only be then that the U.S. Trade Representative would act. Let us say, against a Japanese investor in the industry where an American had been barred because of his abuse of a disclosure role in Japan. So my bill is consistent in also dealing with investment.

Mr. CARDIN. But you would have the U.S. Trade Representative take investment actions against that country, restricting its investment?

Mr. CAMPBELL. Yes; to have the authority to block, to prevent an investment in an American enterprise responsive to and inability to an American to invest in a foreign enterprise.

Mr. CARDIN. Bill, if I may ask you, on the negotiations with the European Community toward a free-trade agreement and trying to put that on a fast track, considering everything that is happening in the European Community today, trying to meet their deadlines of EC 1992 and the problems of other countries in Europe trying to take advantage of some of the actions that are taking place in Europe, is it reasonable to expect that we could make any prompt progress for a free trade agreement with the European Community?

Mr. GRADISON. Well, I don't recall using the term "fast track," but I did mention some possible dates. And the target date that I have suggested, which seems kind of slow to me, to be frank with you, would be to try to complete negotiations on such free trade agreement with the EC by 1995, which is 5 years from now, and then provide for a 10-year phase-in of the provisions, so that import sensitive industries in an extreme case would have 15 years from now to adjust to the new rules or 10 years from the announcement date, the implementation.

I haven't looked back at the exact timing of the negotiations with Israel and Canada, but it's my impression that that would actually be slower, would give more time for the completion of the negotiations if we get started on them sooner than was the case in either of those.

So I—in a sense, it's—my idea is a faster start but not necessarily a fast track. I am very concerned that we send a signal soon that we would be willing to move in this direction if they are. If they aren't, we don't have a negotiation.

And so far as I know, no such signal has been sent, nor has a sounding-out process begun at a high level. And I think that is what we need to do sooner rather than later. That is my main message.

Mr. CARDIN. Thank you.

Thank you, Mr. Chairman.

Mr. GIBBONS. OK.

We appreciate the panel——

Mr. MATSUI. Thank you, Mr. Chairman.

I want to thank all three of the gentlemen for their testimony here today. I was not here when the statements were read, but obviously from listening to my colleagues, the statements were very scholarly and appropriate.

I would just like to ask Mr. Campbell a question, if I may. With respect to your bill, I am very intrigued by it. I am looking on page 10 of our Joint Committee analysis here, and in 1988, all countries invested $328 billion in the United States; Europe, $216 billion; Japan, $53 billion; Canada, $27 billion; and it says all others, which must mean Marcos and Noriega, $31 billion worth of investments, for a total of $328 billion.

You are an economist, Tom, and I have a great deal of respect for your abilities. This amount has increased over the past decade. Can you give me the reason that that has occurred; and second, if these investments were pulled out of the United States, would that have an adverse effect on our domestic economy?

Mr. CAMPBELL. I will try my best. Thank you for your inquiry and the comment.

First of all, I don't think it's likely that the investments would be pulled out of the United States. My bill is to open up an access for an American investment overseas.

And at the conclusion of my testimony, I anticipated that argument and point out that the investments in America are here for a good reason. They are profitable, so that it would be highly unlikely to expect a retaliation to this statute.

Mr. MATSUI. If I may interrupt you. You may have noticed that the long-term bond market has dropped somewhat. Some have attributed that to the foreign investors, who are no longer increasing their rate of investment in the United States as they had been in the past. This has prompted the Fed to change their policies and keep interest rates, both short- and long-term rates, reasonably high, which obviously has an adverse effect on our economy.

So I realize that those foreign investors will act in their own best interests. At the same time, that does have an adverse effect on our economy.

Mr. CAMPBELL. Your point is well taken.

Mr. MATSUI. Go ahead. I didn't mean to interrupt you.

Mr. CAMPBELL. Very helpful contribution, indeed. Indeed, a high amount of foreign investment in bond and stock market has been explained by a number of economists as a factor in the extreme volatility of October 19, of October 13, and recent events in the bond market. But I point out that that is as it ought to be, responsive rate of return.

The premise here was would my bill cause a massive outflow of capital in retaliation for this activity, and there I suggest, no. The profitable reason for investing in America would remain the same.

But should we worry about our financial markets being dominated by large holdings by foreigners, yes. And one of the additional reasons is this: When the dollar goes down, relative to the yen, that affects a Japanese investor far more than it affects an American investor who might buy one-hundredth or one-tenth. But the Japanese investor is going to buy closer to a 100 percent of her or his investments in Japanese goods.

But your first question was profound, and I would like to try my best and make no mistake, our fundamental problem is our budget deficit. I come back to that. I started my testimony with that recognition.

As long as we run a budget deficit of the size we do, we invite in foreign capital. Interest rates stay high. We are not competitive in trade and goods, and as we are not competitive in trade and goods to the tune of about $126 billion, dollars flow overseas.

The books balance at the end of every year, they have to. If we don't trade enough goods, we give them dollars. Those dollars have to invest in a particular place, and believe it or not, over the decade of the 1980's, the investment pattern by foreigners reached a glut; first, the bond market, and actually found a glut no longer interested in bonds, having bought so many, so foreign dollars built up by our budget deficit moved to equity, and that is the story of the last 10 years.

Mr. MATSUI. Well, if I may, Tom, why don't we just try to address the real problem, which is the budget deficit. It appears to me that what you are doing is fine. The problem is the Japanese oppose this. Let's say this legislation passed and we reciprocated with the Japanese. Obviously that could have a rather significant adverse effect on our domestic economy.

So why don't we just try to deal with the fundamental problem instead of playing around in the edges?

Mr. CAMPBELL. More than happy to address the fundamental problem. I disagree, incidentally, that a reciprocity by Japan against us would have a devastating effect on our economy.

Mr. MATSUI. I didn't say that. I said an adverse effect.

Mr. CAMPBELL. I would even dispute the "adverse." But let me get to the heart of it.

Yes, amen, you are right, and at the very start of my testimony, I made an analogy in the trade and goods area to the trade and investment area. What do you do if you have a trade in goods problem? You increase our own productivity. You get interest rates down. And, you try to undo the barriers to your ability to sell goods overseas.

So, also here, what do you do when for the first time, 1988, we have the risk of the investment flows turning negative? You try to get the interest rates down, make your economy more productive, and open up more opportunities overseas.

So, I recognize my solution here is only a partial one, and I will even grant you less by far than half of the fundamental problem. But what it sends is the right signal that we are prepared to deal with unfairnesses in our ability to invest, just as we have dealt with the GATT with our unfairnesses in our ability to sell goods.

Mrs. JOHNSON of Connecticut. Mr. Chairman.

Mr. GIBBONS. Are you through?

Mr. MATSUI. Yes.

Mrs. JOHNSON of Connecticut. Thank you, Mr. Chairman.

As one who is very much involved in the auto parts issue, I hope that we will this year really settle down to the nuts and bolts of this issue of data collection, data availability.

I don't see how we can face the future with the amount of knowledge that we have currently about what is happening in terms of foreign investment in our economy.

There are problems with a solution that Representative Bryant has proposed that have been discussed over the years. But those are problems that we ought to be able to resolve because in fact, as you well point out in your testimony, we are seriously hampered by our lack of knowledge in this area.

And in the auto parts situation, not only do we not have national information, but because we didn't have national information, we could not provoke any substantive response over the years from the Japanese on an issue of tremendous importance to us.

So it impedes our ability to negate or even to discuss our own interests with other countries when we don't have significant data that we can rely on from our own Federal Government.

So, I am very interested in that and look forward to working on that issue in the future. But I did want to ask one question of my colleague, Mr. Gradison.

I have been very concerned about EC-1992 from the perspective of some of our big companies. I, too, see this sense of urgency that is developing for them to transfer certain kinds of investments to the common market nations to be assured of access, and there is no question in my mind but that access is at risk at this point.

Now, I had not thought of a free-trade agreement as an option for us, but certainly it would—it would address some of the developing problems. I hope that there is some way of urging the administration to just address this very issue and make soundings in the near term.

I am talking 6 months, this year, so that we can begin to give some information to our own investing community at the period in the common market development, because I think that in the course of these hearings, we are going to find out rather more than less about the restrictions that are developing and the problems that are being created for American trade with the EC.

Mr. GRADISON. Thank you.

Mr. GIBBONS. Thank you, panel. You have been very fine and very patient.

And now for the next panel, Citizens for a Sound Economy. Excuse me. I am jumping ahead too fast, Institute for International Economics, Fred Bergsten; Organization for Fair Treatment of International Investment Inc., James Carter; Chemical Manufacturers Association, Nancie Johnson; and Florida Bar Tax Section—I hope everybody heard that—Robert Hudson.

Fred, you are first, and you are probably the first for many reasons, but go right ahead.

Mr. BERGSTEN. Alphabetical order is probably an adequate justification.

Mr. GIBBONS. Don't be modest, Mr. Bergsten.

Get close to that microphone and talk loud.

STATEMENT OF C. FRED BERGSTEN, DIRECTOR, INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. BERGSTEN. Mr. Chairman, your central topic today is capital flow into the United States, and I think one should frame that topic by recognizing that the expansion of the U.S. economy over the past 7 years, of which we are all so proud and from which we have benefited, has been financed by foreigners. During that period the net inflow to the United States of capital of all types, direct and other has totaled $800 billion. And so in a real sense the rest of the world has financed our economic expansion.

If we had not had that capital inflow, our interest rates over those years would have been very much higher than they were.

One study we conducted at the Institute for International Economics suggested that, at some point, U.S. interest rates could have been 3 to 5 percentage points higher in the absence of these foreign capital inflows. Rates that high would obviously have choked off the expansion, probably pushed us into a recession, and created enormous financial turmoil. If you think you have problems already with the S&L's, some banks, Third World debt and the like, envisage what the situation would be with interest rates 3 to 5 percentage points higher, and you know how much financial chaos would indeed result. So the sad truth is that the United States has become hooked on foreign capital, and indeed our economic performance in the whole of the 1980's has depended on it.

In the short run the results were good. Foreign capital inflows kept interest rates down, kept the expansion going, and avoided worse financial difficulty than we actually had. But the cost, particularly as time goes on, will turn out to be very high.

A simple and straightforward cost is that of servicing the foreign debt. From the time when we were the world's largest creditor country, as recently as 1983, to the earliest possible leveling off of this buildup in our foreign debt in the early to mid-1990's, the swing in our net investment income will be something like $100 billion per year. I think Mr. Campbell referred to that fact in his testimony. Even if we level off this expansion of the debt, even if we get rid of the current account deficit, even if we stop borrowing more at the earliest possible time, somewhere between 1992 and 1995, we will be left with a legacy of $100 billion per year of debt-servicing deterioration that the country will have to pay forever into the future. That is a straightforward and simple cost.

A second cost, to which Mr. Matsui was just referring, is the need to keep interest rates high to keep the foreign money coming. Indeed, we have to keep interest rates high just to keep the money that has already come in from going back out. But in addition we have to attract $10 billion more of foreign capital every month to keep financing the deficits, to keep interest rates from shooting up, and to keep the economy from going into a tailspin. Therefore, among other things, we have to keep interest rates high. That obviously has effects on the domestic economy that are not always happy.

Third, our dependence on foreign capital makes us incredibly more vulnerable to economic and even foreign policy decisions made outside our borders. I thought Mr. Bryant put it very nicely when he said we have paid for our deficits with our sovereignty. It's a pleasure to underline Mr. Bryant's comment. I think he was right. We are going to be more vulnerable, and decisions made abroad are going to affect us increasingly.

The United States was dependent on the rest of the world already, as part of an interdependent world economy. This shift to debtor status did not create our dependence on the rest of the world and on foreign capital, but it did increase it enormously. And I think the change is so great that it has become a qualitative difference.

And finally, on any given day, as Mr. Matsui was just saying, we are subject to the so-called hard landing risk. If at any point foreign investors decide they are unhappy with our interest rates, or the way we are managing our economy, or our growth outlook, or maybe even our foreign policy, they might stop putting new money into the United States and pull their old money out, at which point the dollar would plummet, our inflation rate would soar, and our interest rates would soar even further. This is the hard landing scenario that I have discussed frequently before the committee and therefore won't elaborate upon now.

That in summary is the state into which we have put ourselves with our twin deficits, and I think it's the reality that confronts this committee now in every decision it has to make.

One component of this capital inflow that has attracted particular attention, and that you are focusing on today, is foreign direct investment. My institute has just published a major study of this topic called "Foreign Direct Investment in the United States." We have made copies of that study available to all members of the committee. The study tries to lay out a comprehensive and balanced analysis of the causes of the phenomenon, its effects, its implications, reciprocity concerns vis-a-vis the rest of the world, and all other aspects of the issue.

I obviously don't have time to go into all of those issues, but let me just tick off a few points. When the huge U.S. dependence on foreign capital escalated sharply in the early to mid-1980's, most of the capital inflow was in the form of portfolio investment. Japanese and other investors were buying Treasury notes, bank deposits, certificates of deposits, and the like. But as these investors became increasingly sophisticated and knowledgeable, and as they wanted to hedge their investments against the risk of inflation in our economy and a lower dollar, they shifted to other, real assets, meaning companies, real estate, and the like.

In 1988, about half of the net foreign capital inflow into the United States took the form of foreign-direct investment. We don't have the full numbers yet for 1989, but in that year it may have been as much as two-thirds.

This foreign-direct investment phenomenon is not really caused by our current account deficit but has more to do with the increased competitiveness of foreign-based firms in the world economy, as well as the desire to participate in our economy, and protectionist threats here, both real and feared for the future. Nevertheless foreign-direct investment has now become the lion's share of the total financing of our external deficits. That means that we couldn't cut it off even if we wanted to, even if we were to conclude that foreign-direct investment was a terrible thing, that it bled jobs away instead of creating them, or that it undermined our sovereignty in terrible ways. Frankly, Mr. Chairman, at this point, we could not impede it because we have to have it.

Now there are some who say you could reject the direct investment and force foreign investors to go back to buying bonds, putting their money in bank deposits, and the like. I think that is clearly not the case. If we said to foreign investors that the dollars they bought yesterday have suddenly become inconvertible for some purpose, that they could no longer put them into plants or real estate here, they would begin to wonder whether they are going to be told tomorrow that their dollars will become inconvertible for some other purpose. And, in fact, that would create enormous capital flight. Therefore, don't be beguiled by the argument that we can calibrate this capital inflow by cutting out some parts of it, letting others continue, and shaping the composition of it in the way that we want.

Fortunately that is not an issue. Our study tried to look comprehensively at the effects of foreign direct investment on the economy. It compared foreign-based firms here, including Japanese-based firms separately, with American firms on a variety of criteria: How much do they spend for R&D? What wages do they pay?

The comment is sometimes heard that foreign firms may take the good jobs home, may do all the good R&D at home, may bleed us of technology. The data do not support that. The amount of R&D per worker among foreign-owned firms here is about the same as for U.S.-owned firms. The wages paid per job and the value added per job for foreign-based firms in the United State are about the same as for U.S.-based firms, and that is true for Japanese subsidiaries as well.

There is one key area where a difference shows up. That is in the propensity of foreign-based firms to import their inputs. Foreign-based firms in general tend to import about three times as much as do indigenous American firms as a share of their value added. Moreover, Japanese-based firms tend to import about six times as much—double what the other foreign-based firms import as a share of their value added. Therefore, the one major issue we flag for keeping a close eye on is whether in fact these foreign-based firms are procuring locally, using local suppliers—whether it is auto parts or other products—as much as they really should as they become American companies.

We cannot say for sure why that difference exists. It may be in part because the foreign-based firms are newcomers. We know from the experience of U.S. firms investing abroad that they tend initially to take their own components with them. They tend to get capital equipment from home as they set up. Then, as they become more familiar with and ingrained in the local economy, they begin to increase the local content in their output.

It may simply be that the foreign-based firms, particularly the Japanese firms, are so new to this country that we are still seeing that life-cycle phenomenon. We don't see any large negative effect as yet from this tendency to import. We note that those foreign-based firms here are also exporting, and that may help the trade balance. But that is one issue that we suggest be watched very closely, because there may be adverse effects to which policy at some point might want to address itself.

The other area in which we raise a concern is national security. In a world where technology is globalized, the multinationalization of business could have an adverse effect on our national security establishment and our ability to get the highest available technology for our military establishment at all times.

That may imply that we should reject foreign investment that would take over the last American producer of some key technology. It may also imply that, when we are dependent on foreign firms for high technology, we should require them to invest in the United States in order to get some of that technology within our boundaries. We may, in fact, want to use foreign investment in the United States in a positive way to try to ensure our access to those particular technologies that are critical to the defense establishment.

Those are areas we flag as possible problems. But, in the aggregate, we think foreign direct investment in the United States is positive, indeed essential, given the overall problem we have got ourselves into.

At the end of the day, I would simply underline what Mr. Gradison was saying, as well as Mr. Matsui and other members of the committee. We have to get off the foreign capital hook, or else our whole policy environment is going to be constrained for the indefinite future. That means going to work at home on the budget deficit, our low savings rate, and lots of other issues that we have discussed many times before the committee.

Mr. GIBBONS. Before you close, will you tell the committee how you get this information, and they won't give it to Mr. Bryant.

Mr. BERGSTEN. Mr. Chairman, I don't think we got any information not available to Mr. Bryant. I had some very diligent researchers who were plowing the field aggressively and creatively, taking the available data and analyzing it in new ways. We do, incidentally, address Mr. Bryant's amendment in our book, and we address his questions. In fact, we suggest in an appendix to the study some changes that could be made with respect to data availability, the reporting requirements, and the like, that we think could improve the data base.

But our bottom line is that the data currently available are adequate for most purposes. We have, in fact, surveyed other researchers in the field, and that seems to be a pretty widespread conclusion. You can always get better data if you spend more money. You can get more reporters, you can have more people monitoring and analyzing the data, but at the end of the day we do not see a need for the type of amendment that Congressman Bryant is proposing.

Mr. **Gibbons**. You send me a copy of your book, and I will pay for it; will you?

Mr. **Bergsten**. Mr. Chairman, I am delighted to increase the revenues of the institute contributed by the Ways and Means Committee.

Mr. **Gibbons**. Let's go to the next witness.

Mr. Carter.

STATEMENT OF JAMES M. CARTER, SECRETARY, ORGANIZATION FOR FAIR TREATMENT OF INTERNATIONAL INVESTMENT, INC.

Mr. **Carter**. Mr. Chairman, members of the committee, we thank you for inviting the Organization for Fair Treatment of International Investment, and we are honored to testify before you today.

We are, in fact, members of the direct foreign investments that we have been talking about here all morning. Organization for Fair Treatment is composed entirely of the U.S. subsidiaries, or for the most part, European manufacturing companies. The names of many of our members are certainly well known to all of you, AKZO, Siemens, Volvo, Volkswagen, Imperial Chemical, just to name a few of them.

But what I want to emphasize is that our members are not foreign companies. We are incorporated in the United States, our plants and facilities are located in the United States, and our members employ well over 100,000 U.S. citizens in virtually every State.

We invest billions of dollars in the United States, and we manufacture in the United States and export abroad. And we pay taxes in the United States.

Our members' principal sources of capital, of course, are foreign; but it must be noted that our foreign parent companies are themselves publicly held companies with their shares traded on the major stock exchange of the world, including in many instances the New York Stock Exchange.

What is of crucial importance is that the OFTII companies and other foreign subsidiaries are an integral part of the U.S. economy without which all of us would be much poorer.

The Bureau of Export Administration's 1987 benchmark survey of foreign direct investment in the United States has shown that U.S. affiliates of foreign companies provided more than 3 million jobs and supplied about 8 percent of all plant and equipment spending in the United States for that year.

Now, there are numerous examples, probably in each one of your districts, of the positive influence that foreign investment has had on restoring the economies of depressed and chronically unemployed communities.

Let me just cite a few. The town of Manistee, MI, was largely dependent upon the Diamond Crystal Salt Co. for employment. When they were about to close the plant in 1988, AKZO, a Dutch affiliated OFTII company, acquired Diamond Crystal plant and saved 250 jobs in this small town.

I imagine this incident is known to one of your colleagues, Mr. Vander Jagt. AKZO then proceeded to expand this plan and create more jobs in the town than Diamond Crystal had.

They similarly doubled the capacity of a small manufacturing plant in Millsboro, DE, that made animal health products. They brought in new product technology, and they are currently planning further expansion.

Now, my own company, ICI Americas, which is affiliated with Britain's Imperial Chemical Industries, expanded from 5,000 employees and $250 million in sales in 1971 to 20,000 employees and more than $4 billion in sales in 1989, largely as a result of infusion of British capital and British technology, including two of the most widely prescribed drugs for heart disease and breast cancer used today, and that is to say nothing of a variety of products that would take more time than this entire panel is allowed for me to list.

Now, many of you may be aware of another instance that was cited by your colleague, Representative Tom DeLay of Texas, of Australian investors to help save the American West Airlines of Phoenix, AZ, from going into bankruptcy and helping them maintain the competitiveness of air service in the United States.

In a recent study by Norman Glickman, it was noted that investment by foreign manufacturers in 12 Southern States represented 78 percent of all greenfield manufacturing in those States for the 1979 interval, raising employment by those foreign affiliated companies to more than 700,000.

Samuel Roseblatt, president of the Association of International Investment, recently pointed out that inflows of foreign capital have enabled the U.S. economy to overcome shortfalls in the national savings rate and have kept interest rates from rising without having to endure a major recession.

I think Mr. Bergsten mentioned that this morning. These foreign capital flows have been the balancing factor between the domestic demand for capital and the domestic shortfall in savings.

Now, the reason foreign investment is attracted to the United States in the first place is because the United States has a secure economy, it has an expectation of high productivity, and it certainly is one of the world's largest market areas, and it has a scarcity of domestic capital to supply the needs of this growing economy.

Foreign direct investors are not fly-by-nighters or hit-and-run investors. Factory headquarters complexes, research facilities, distribution facilities, and trained and dedicated workers are not assets that are easily acquired nor easily disposed of.

OFTII members are not taking away from the United States. They are reinvesting more heavily here because they are betting on the future of the global economy and the place of the United States in that economy.

The fact is that technology has grown so complex and research development projects so sophisticated and expensive that no regional economy, even one as large as the United States, can support the enormous expenditures necessary to bring new products to market. This is particularly true in high tech fields such as aerospace, agricultural chemicals, electronics, and medicine.

No one, foreign or domestic, is going to risk millions in development costs over time intervals for as long as 10 years unless he can market those products globally.

Europe in 1992 will become a regional market larger than the United States and United States business, whether domestic or foreign owned, we will have to find ways to operate in that market, as well as the United States, to say nothing of other developing areas of the globe.

U.S. Government policy should be directed toward welcoming the global market and helping the United States play a significant role in it. Last year's tax bill included a number of provisions that were vigorously opposed by OFTII members, because our members regarded it as a discrimination against U.S. corporations, largely on the ground that they were affiliated with foreign shareholders.

While this is not the time or place to reopen that battle, we do hope that 1990 will not bring even more discriminatory measures. U.S. policy should welcome the advent of the global market and not discourage it. If the United States does not become an active participant in that market and recognize that U.S. business must compete as actively abroad as at home, our economic power and influence will wane.

There is no longer any place in the world for isolationism, whether it's economic, political, or social. The United States has been a leader in the past in free trade and breaking down of economic barriers among nations, and we should not now abandon that role on the threshold of the 21st century.

I thank you.

[The statement of Mr. Carter follows:]

STATEMENT OF JAMES MERLE CARTER, SECRETARY, ORGANIZATION FOR FAIR TREATMENT OF INTERNATIONAL INVESTMENT INC. (OFTII)

The Organization for Fair Treatment of International Investment (OFTII) is composed exclusively of the United States subsidiaries of foreign companies, most of whom are engaged in manufacturing. There is annexed a list of OFTII members who support this statement. It should be emphasized from the outset that these are U.S. companies, employing more than 100,000 U.S. citizens, and contributing billions of dollars to the economy of the United States. The investments represented are long term, and reflect faith in the viability and security of the U.S. economy. These are direct investments in plant, machinery, and equipment -- assets that can neither be easily liquidated nor transported abroad. These investments do not represent the "buying of America." Rather they reflect the belief that the U.S. is a great marketplace and by participating in that marketplace with new capital, new technologies, new managerial techniques, both the investor and the marketplace, will profit.

The United States cannot at this moment in history claim to be the home of all that is innovative and robust in technology and production. In the last century, the U.S. borrowed heavily from foreign technology and industrial practices and improved upon them. The steam engine, the gasoline engine, the diesel engine, and radio communication were all invented in Europe, but developed and exploited in the U.S. to become the foundation of our 20th century economy. After World War II, foreign economies, in some cases destroyed by the war, rebuilt along modern lines and began to improve upon the latest in U.S. technology. Those improvements are now flowing back into the U.S. to satisfy the demands of U.S. consumers for the most up-to-date technological advances. The U.S. is still the world leader in aerospace, in computer technology, pharmaceuticals, and chemicals. But part of this leadership is due to the fact that foreign investors have poured their own capital and technology back into the U.S., particularly in chemicals and electronics, so that they too can participate in the world's greatest marketplace.

The 21st century promises to be the century of the global marketplace. While no one is suggesting that nationalism is to be put aside, economic and, ultimately, political survival is going to depend upon the ability to compete efficiently in the global marketplace. If Europe after 1992 proves to be a more attractive marketplace than the U.S., investment of dollars as well as other currencies will gravitate there. No longer will the U.S. consumer be able to afford the high level of goods and services he now enjoys from both foreign and domestic sources. An economy that is directed inward and penalizes or restricts the contribution that foreign investment offers is likely to stagnate and will certainly become non-competitive. Eastern Europe, India, and most of South and Central America are prime examples. What the United States must do, and this Committee's role is a crucial one in the process, is to find means to encourage investment in enterprise from both foreign and domestic sources in ways that will promote competitiveness, increase domestic employment, enlarge return on investment, and develop new technology. Obviously, the foreign investor should not expect nor is he entitled to preferential treatment over domestic investors. At the same time however the foreign investor should not be singled out for negative tax and investment treatment, different from domestic investors in the same or similar industries. The key to success for this program is removal of restrictions that put U.S. business at a competitive disadvantage in the world marketplace. Obvious examples of such restrictions are incredibly complex federal rules on foreign tax credits and failure to abolish taxation of foreign source income by certain States through use of worldwide "unitary" taxation.

Too often press accounts ignore the positive side of foreign direct investment in the U.S. Fully two-thirds of it provides additional capital as well as new management practices and technological innovations that add to increased labor productivity. This, in turn, leads to higher wages for U.S. workers and promotes U.S. competitiveness in the world market. A frequently cited example is that of Japanese automobiles manufactured in the U.S. that are considered superior to the same automobiles manufactured in Japan. Perhaps the principal demand for foreign capital results from the very low rate of domestic savings. Until this frequently documented phenomenon can be changed, U.S. industry must look to foreign sources to maintain a high rate of capital spending. It is, indeed, the increase in the rate of capital spending during the 1985-1988 interval that produced the productivity growth of an annual average of 3.3%. This was a full percentage point higher than the previous interval, according to Under Secretary of Commerce Michael Darby in his September 21, 1989, "Remarks on Foreign Investment and the State of the Economy." Mr. Darby further pointed out that preliminary results of the Bureau of Export Administration's 1987 benchmark survey of foreign investment show that U.S. affiliates of foreign companies provided, directly or indirectly, 3.2 million U.S. jobs and supplied about 8% of all U.S. plant and equipment spending in 1987. At the State level, California is the leading beneficiary of affiliate employment with some 324,000 jobs.

In many parts of the U.S., foreign investment gives small towns and rusted industrial cities that are unable to attract domestic capital a real economic opportunity. Some examples are Winslow, Arizona (pop. 8,900) which induced a Korean company to buy and activate a long-dormant underwear manufactory on Hopi Indian Reservation land. The refurbished factory now provides 80 new jobs and produces $2 million worth of sports caps annually. In Fontana, California, a joint venture of Brazil's Rio Doce Geologica y Mineracao and Japan's Kawasaki Steel reopened a foundry closed since 1983. It now employs 800 workers and produces 1 million tons of steel a year.

In many industries, domestic markets, even the vast U.S. market, are too small to warrant the enormous expenditures for research and development needed to improve existing technology. A prime example is the pharmaceutical business. In the 1980s, it took about $250 million to develop a new drug over a time span of as much as 12 years. Only a global market can support that much capital risk. David Friend, head of the Pharmaceuticals Division of Imperial Chemical Industries, was quoted in the August 28 issue of Fortune as saying "No major pharmaceutical company is in the game for anything other than global products." It is the development of this global outlook in pharmaceuticals that explains a series of mergers of major drug companies such as Bristol-Myers with Squibb and SmithKline with Beecham's. Development of this global outlook has also caused business to be less concerned with the location of their manufacturing facilities and more concerned with the market conditions of the locations chosen, i.e., the likelihood of future investment in the industry in the chosen location. Under Secretary of Commerce Darby noted, for example, that corporate policy at Motorola does not discriminate in favor of U.S. production facilities in allocating high value-added manufacturing functions to its factories around the world. Similarly, Goodyear channelled $207 million (28%) of its capital spending to building or upgrading foreign facilities in order to reach adjacent foreign markets. NCR, a company that characterizes itself as globally competitive, collected 60% of its $6 billion in revenues from sale of products made in foreign factories.

It should be fairly apparent that foreign investment in the U.S. represents a vote of confidence in the health, safety, and productivity of the U.S. economy. Policies that penalize foreign investment merely because it is foreign can only drive away this important source of capital for expansion of the U.S. economy to the detriment of jobs, particularly in the manufacturing sector, and to the detriment of the U.S. consumer to acquire state-of-the-art consumer goods at the lowest competitive prices. Capital performs the same function irrespective of its source, and sound investment has no national bias. As a practical matter, earnings by foreign investment never leaves the U.S.

Let me narrow this point to my own company, ICI Americas Inc. We are 100 percent owned subsidiary of ICI of the UK. ICI Americas generates over $4 billion in sales annually. Over several years we have invested in excess of $4 billion in the U.S. We have never paid a dividend back to our parent company. All the cash we have generated, we have used to expand our business in the U.S. Whenever we have had a cash surplus, and we do sometimes manage that, we invest in ourselves here, we invest overseas, or we invest with our parent company--by making loans to the parent. When we lend money to our parent, they pay us interest on that money, and we pay tax in the U.S. on the interest. Of that $4 billion of sales, only about 7 percent is imported, and about 10 percent of our production is exported from the U.S. In other words, in this and many ways we behave and perform like a normal U.S. corporation would, by reinvesting in our future here in the U.S. market.

International investment is a seamless web of trade payables and receivables with funds being shifted electronically from one account to another in the same international banks. Trade current account deficits must be made up by countervailing capital flows to balance them. Were it otherwise, our constant trade deficits with foreign countries would have created huge dollar reserves abroad with no place to go and the dollar would have become so devalued that little could be purchased with it in foreign markets. Instead of being one of the strongest currencies in the world, the dollar would have become one of the weakest.

One of the problems facing the U.S. economy is the high cost of capital. This is, admittedly, an area in which many foreign investors have an advantage because of the relatively lower costs of capital in their home countries. The solution appears to be, however, not to increase the cost of foreign capital to a point where the flow into new investments is stemmed, but to make U.S. capital more competitive. Part of this is a function of U.S. tax laws that make equity more expensive than debt and tax capital gains at the same rate as profits. The object of federal tax reform should be to make the U.S. investor who wishes to invest in the global economy competitively equal to the foreign investor in the same economy. This will not be accomplished by penalizing the foreign investor because he is foreign, but rather by rewarding the efficient investor irrespective of the source of his capital.

The U.S. subsidiaries of foreign companies are not, themselves, foreign. They are subject to the same laws, pay the same taxes, and compete in the same marketplace as their domestically owned competitors. They are, for the most part, managed by U.S. citizens and they do not serve foreign political interests. Their purpose is precisely the same as domestically owned companies -- to make a profit and a return on capital for their shareholders. Whatever advantage foreigners may enjoy in terms of cost of capital can and should be removed by uniform tax and regulatory practices that put all capital on an equal footing and encourage investment in new technology and increased productivity. The nation that fails to participate in the global economy on a parity with other nations will soon find itself sliding ineluctably into the economic isolation suffered by third world and Eastern Bloc nations that must trade natural resources for manufactured goods and advanced technology from more economically advanced nations.

There appears to be a perception that foreign multinationals enjoy a lower effective tax rate on U.S. source income than they should. While the statistics that presumably demonstrate this (drawn from the Treasury's Statistics of Income publications) are not specific enough to pinpoint cause, it should be clear that any loss of tax revenue on U.S. source income to a foreign multinational could only arise through transfer pricing practices or distributions of earnings disguised as debt repayments. There are no exceptions in the Internal Revenue Code for U.S. subsidiaries of foreign parent companies. Both the transfer pricing issues and the "earnings stripping" issue have recently been addressed by Congress and Treasury implementation of these provisions in the form of regulations is underway.[1]

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[1] As this Committee knows, the members of OFTII strongly opposed enactment of the "earnings stripping" and increased record-keeping provisions which were enacted in the 1989 Budget Reconciliation bill. Our main objection was that these provisions unfairly singled out foreign-owned companies for harsher treatment under our tax system than otherwise identical domestically-owned companies. Such discriminatory treatment violates our tax treaties with our closest trading partners and jeopardizes the entire world open trading system. While OFTII does not wish to use this hearing to re-open a closed debate or to dwell on this recent battle, we must remind the Committee that such costly and discriminatory legislation not only does not encourage increased investment in the U.S., but punishes existing investment in manufacturing, plant and equipment here. Further legislation in this area--differential tax treatment or other investment restrictions--would represent an alarming trend and would be counter productive to needed growth in the U.S. and indeed the global economy.

What the statistics do not demonstrate is whether any presumed revenue loss occurs because of start-up costs in new enterprises and new factories established by foreign investment. We do not believe there is any revenue loss occurring in the manufacturing sector, irrespective of the nationality of its shareholders. It is the manufacturing sector affiliated with foreign investment that has generated the most employment in the U.S. in recent years. The same Fortune magazine article referred to earlier stated that from 1979-1983, nearly 40% of all foreign-owned manufacturing start-ups in the U.S. -- such as the Nissan Motor Co. Ltd. plant in Tennessee and the Lucky Gold Star consumer electronics facility in Alabama -- occurred in southeastern states. As a result, by 1985, the U.S. affiliates of foreign companies employed 706,000 people in 12 southeastern states -- including 116,000 in Georgia.

It is, of course, this Committee's function to enquire and to determine whether the tax laws do indeed provide an unfair advantage to foreign investors or any other sector of the U.S. economy. We do not believe that a careful enquiry will reveal there is a manifest disparity that favors foreign investors. If there is, we are unaware of it and agree that it should be removed. But we do not believe that penalizing or restricting the flow of foreign capital into the U.S. economy will benefit anyone, domestic or foreign. The U.S. has traditionally and historically pointed the way to a free market economy and the world is far better for it. There could be no better proof of this than the events in Eastern Europe and the collapse of the closed and xenophobic economies of those nations. The U.S. market is what it is today because of its free market orientation, not in spite of it. National tax and fiscal policy should be pointed toward preserving and improving upon what has already been achieved, not stepping backward into an isolationist doldrums such as existed here and throughout most of the world in the Great Depression of the 1930s.

The opportunity to present these views to your Committee is greatly appreciated.

ORGANIZATION FOR FAIR TREATMENT OF INTERNATIONAL INVESTMENT (OFTII)

AKZO AMERICA, INC.
ALCAN ALUMINUM CORP.
ALLIED-LYONS NORTH AMERICA CORP.
BASF CORP.
BEECHAM, INC.
BOC GROUP INC.
BP AMERICA CORP.
ENGLISH CHINA CLAYS
FOSECO MINSEP
GOLD FIELDS AMERICAN CORP.
GRAND METROPOLITAN
PILLSBURY COMPANY
HOECHST-CELANESE CORP.
HOFFMAN-LaROCHE, INC.
ICI AMERICAS, INC.
MOET-HENNESSY U.S. CORP.
NESTLE HOLDINGS, INC.
NESTLE ENTERPRISES, INC.
NORTH AMERICAN PHILIPS CORP.
PECHINEY CORP.
REED SERVICES INC.
SHELL OIL COMPANY
SIEMENS CAPITAL CORP.
SONY CORPORATION OF AMERICA
THORNE EMI (USA), INC.
UNILEVER UNITED STATES, INC.
VOLKSWAGEN OF AMERICA, INC.
VOLVO OF NORTH AMERICA CORP.

Mr. GIBBONS. Thank you, Mr. Carter.
And now, Ms. Nancie Johnson.

STATEMENT OF NANCIE JOHNSON, MANAGER, INTERNATIONAL TRADE AND INVESTMENT, E.I. DU PONT DE NEMOURS & CO., ON BEHALF OF THE CHEMICAL MANUFACTURERS ASSOCIATION

Ms. NANCIE JOHNSON. Good morning, Mr. Chairman, members of the committee. My name is Nancie Johnson, and I am manager for international trade and investments with the Du Pont Co. I am here today talking on behalf of the Chemical Manufacturers Association, the CMA. We welcome this opportunity to discuss international direct investment for the committee.

There are two facets of this subject that concern us, investment flows in and out of the United States, and the multilateral negotiations on trade-related investment measures which are taking place under the auspices of the GATT. CMA represents companies that account for 90 percent of the productive capacity for chemicals in the United States.

CMA members include U.S. based companies with significant investments abroad, as well as U.S. subsidiaries of foreign based corporations. Consequently, we have a substantial interest in deliberations related to international direct investment.

In CMA's view, the unfettered flow of international direct investment is vital to the chemical industry's strong international competitive position. Such investment allows companies to operate world class businesses by enabling them to better serve large foreign markets. Large sales volumes that can be realized from global markets are also necessary to help us amortize R&D costs over a broad base. International investment also provides an important hedge against exchange rate fluctuations.

In addition, direct investment offers a means to avoid existing and potential trade barriers.

Finally and perhaps most importantly, unrestricted international direct investment is a critical ingredient in the strong, positive contribution the chemical industry makes to U.S. international accounts. According to official Commerce Department statistics, foreign-direct investment in the U.S. chemical industry is somewhat larger than investments held by the United States abroad; $34.1 billion versus $30.5 billion in 1988.

Similarly, the U.S. chemical industry is one of the most foreign controlled of U.S. industries, yet current data show the strong international competitiveness of the U.S. industry as a whole.

In 1989, we registered a trade surplus of $16 billion and net income from international investments that should match the 1988 total of about $4.3 billion. We expect a $20 billion total in 1989.

In addition, data compiled by the Commerce Department show exports from foreign controlled U.S. chemical companies totaled $5.2 billion in 1987, which was the last year that data, such data were available, while imports totaled only $3.7 billion, yielding a trade surplus of $1.5 billion.

Also, the majority of income earned by foreign chemical companies from the direct investments in the United States is reinvested here rather than repatriated, about 73 percent in 1988.

The data that I have presented make it clear that the U.S. chemical industry is a positive contributor to the U.S. balance-of-payments, and that the international direct investment plays a key role in our trade performance, thus CMA opposes the imposition of unnecessary barriers through direct investment in the United States.

We also oppose the imposition of such barriers by foreign governments. We believe, therefore, that our trade policy officials should focus their efforts on the development of international disciplines that will reduce trade distorting investment policies world wide.

CMA has recommended that the United States pursue a two-part strategy. First, the United States Government should push for the incorporation of trade related investment measures into the GATT.

Second, the United States should build on its existing bilateral agreement program to focus on those countries which impose the most restrictive investment policies.

Currently the major emphasis is obviously on the GATT TRIM's negotiations. We at CMA are encouraged by recent progress in these negotiations.

We support the U.S. position of outright prohibition of clearly trade-distortive investment restrictions. We welcome the U.S. suggestion that for those TRIM's not prohibited by the GATT, government should commit to supply them on a nondiscriminatory basis and in ways that do not distort trade.

The chemical industry's stake in international trade and investment will be enhanced by improved disciplines over restrictive investment measures. We believe moreover that the credibility of our negotiators in seeking the reduction of foreign barriers to direct investment could be undermined if the U.S. imposes new restrictions on foreign direct investment in the United States.

In conclusion, CMA is convinced that foreign direct investment per se poses no danger to U.S. economic interests, and that restricting such investment could erode U.S. international competitiveness.

CMA urges that U.S. trade policy focus on a multinational approach to achieve more open investment policies worldwide.

Thank you.

[The statement of Ms. Johnson follows:]

STATEMENT OF THE CHEMICAL MANUFACTURERS ASSOCIATION

I. Introduction

The Chemical Manufacturers Association (CMA) appreciates this opportunity to testify before the House Ways and Means Committee on issues related to foreign direct investment in the United States (FDIUS). The nature and extent of FDIUS and the relationship of U.S. direct investment abroad (USDIA) have become important issues in the public policy debate surrounding the trade balance, the budget deficit, and our economic future.

CMA is a non-profit trade association whose member companies represent 90 percent of the production capacity for basic industrial chemicals in the United States. CMA's members include U.S.-based companies with significant investments overseas, and companies in the United States that are the investments of foreign-based corporations. Consequently, the U.S. chemical industry has a significant interest in discussions concerning international direct investment and potential restrictions on it.

In CMA's view, the free flow of international direct investment -- both from and into the United States -- is critical to the chemical industry. Recent data shows that the chemical industry's international investments positively contribute to the Nation's trade and current account balances. CMA does not support the imposition of any restrictions on international direct investment, whether here or abroad.

As part of its continuing advocacy related to the Uruguay Round of the Multilateral Trade Negotiations (MTN) in the General Agreement on Tariffs and Trade (GATT), CMA has encouraged the U.S. government to support an agreement limiting restrictions on international investment. This agreement should be based on the principle of national treatment for foreign investment, and should assure reduction or elimination of trade-distorting investment practices. CMA is hopeful that the conclusion of the Uruguay Round this year will see significant progress on international investment disciplines.

The U.S. chemical industry's recent experience clearly demonstrates the importance of international investment. Foreign affiliates of U.S. companies, and U.S. affiliates of foreign companies, combined to contribute $4.9 billion to the industry's merchandise trade surplus in 1987, the most recent year for which such data are available. The industry's total international transactions balance in 1988 was an impressive $16.6 billion surplus, including merchandise trade, direct investment income, royalties and license fees, and other services related to the industry's direct investments. U.S. chemical industry income from its direct investments continues to exceed the income of foreign investments in the industry, and the prospects are for continued growth during 1990. In short, foreign investment in the U.S. chemical industry and U.S. investment overseas helps the industry to compete globally. Unwarranted restrictions on investment would negatively affect the industry's future competitiveness.

II. International Investment and GATT Negotiations

Since 1987, the Contracting Parties to the GATT have been negotiating amendments to the agreement, working primarily in 15 separate negotiating groups. Work on trade-related investment measures (TRIMs) has included an exhaustive analysis of TRIMs, case studies of their use, consideration of the relationship of TRIMs to traditional trade policy concepts, and a review of their trade-distortive effects. The July, 1989 submission of the United States government in the TRIMs negotiations aptly summarized concern over the use and effect of restrictive investment practices:

> The Group's work to date has revealed much about TRIMs. TRIMs are widely used, and they have adverse effects on trade. TRIMs are often used in an ad hoc, non-transparent and discriminatory manner. Their relationship to the General

> **Agreement is complex. Some TRIMs are clearly inconsistent with GATT provisions; others are not. Some TRIMs are inherently trade-distorting (regardless of their legal status vis-a-vis the GATT); others distort trade in some but not all circumstances. MTN.GNG/NG12/W/15 at 2 (Submission of the United States, July 7, 1989).**

A 1983 survey of CMA member companies revealed an array of investment restrictions that governments impose on capital investment within their countries. These restrictions fall into six major groups:

1. Restrictions or prohibitions on foreign investment in specific economic sectors (e.g., chemicals);
2. Screening of all foreign investment by government agencies which have the authority to restrict or prohibit specific foreign investment;
3. Limitations on the amount or percentage of equity that a foreign investor may hold in an enterprise;
4. Requirements that a foreign investor purchase some or all of its capital equipment or raw materials from within the country;
5. Restrictions on royalty or licensing payments from the domestic partners to the foreign entity supplying the technology; and
6. Restrictions on the remittance of earnings to the foreign investor or on the investor's ability to repatriate its capital.

In general, three categories of adverse trade effects are produced by TRIMs. Imports may be reduced, caused by TRIMs which favor domestic products over similar imported products, or which act as a restriction on imports. Exports may be increased by TRIMs which require the investor to export stipulated amounts of product. Exports may also be reduced by investment policies which discourage exports or which function as quantitative restrictions on exports.

In order to effectively reduce and eliminate TRIMs, CMA has recommended that the U.S. government undertake a two-part strategy. First, the U.S. government should pursue the incorporation of a TRIMs agreement in the GATT. Second, the U.S. should build upon its existing bilateral investment treaty program to focus on countries which impose the most restrictive investment policies, and which hold the promise for enhancing current or potential U.S.-owned investments.

CMA is very encouraged about the progress of the GATT TRIMs negotiations thus far. The position of the United States in advocating outright prohibition of clearly trade-distortive investment restrictions is especially welcome. Providing an illustrative list of prohibited TRIMs -- a device used with some success in the GATT Subsidies Code -- should help delineate the permissible bounds of national investment policies. Perhaps more importantly, the U.S. government has suggested that for those TRIMs not expressly prohibited by the GATT, governments commit to apply them only on a non-discriminatory basis, and in ways that produce no trade-distortive effects. CMA strongly supports these negotiating objectives.

Throughout the remainder of the Uruguay Round, CMA will be seeking the support of the foreign chemical industry for further development of of a GATT discipline on TRIMs. Issues related to transparency in national investment policies, enforcement and dispute settlement, and the transitional needs of the GATT parties remain to be decided. It is certain, however, that the chemical industry's major stake in international trade and investment will be greatly enhanced by better international rules prohibiting restrictive investment measures. U.S. credibility in negotiating the reduction of foreign barriers to direct investment would, of course, be reduced by new restrictions on foreign direct investment in the United States.

III. Foreign Investment in the U.S. Chemical Industry: Extent, Impact and Relationship to U.S. Investment Abroad.

Growing foreign ownership and control of U.S. businesses and real estate is a clear manifestation of the extent of international capital flows. Concern has been expressed that foreign control of U.S. businesses threatens our national economic future. The chemical industry's performance shows, however, that foreign investment is a positive factor in the industry's continued growth and expansion. Far from stripping the industry of critical assets, foreign investment has made the industry more competitive and helped strengthen the U.S. economy.

Using standard definitions, the chemical industry is more "foreign controlled" than other major manufacturing industries. FDIUS in the chemical sector totalled $34.1 billion in 1988, compared to $30.5 billion in U.S. chemical direct investments overseas. Foreign controlled U.S. companies as a whole employed only 7.3 percent of the U.S. workforce in 1987; yet 23.5 percent of the chemical industry's employment is in foreign controlled firms. Foreign investment in the U.S. was responsible for only 11.5 percent of all manufacturing sales in 1987, but nearly 32 percent of the chemical industry's sales that year were by foreign controlled entities.

Under one view of foreign investment effects, the chemical industry's control by foreign investors should have had a negative effect on the Nation's trade balance. Data related to the U.S. chemical industry provides a more accurate picture of foreign investment effects, and in CMA's view show that restrictions on foreign investment would likely have severe effects on the industry's future competitiveness. Graphics related to the chemical industry's international direct investment appear in Appendix 1 to this testimony.

The U.S. affiliates of foreign chemical companies also makes a positive contribution to the trade balance. According to data developed by the U.S. Department of Commerce, chemical exports from foreign-controlled U.S. chemical companies in 1987, the most recent year for which data are available, were $5.2 billion. Only $1.7 billion of these 1987 exports went to foreign parent companies. Imports by the same foreign-controlled U.S. companies were $3.7 billion, resulting in a U.S. surplus on chemical trade by these foreign-controlled companies of $1.5 billion. Also, in 1987, the foreign affiliates of U.S.-origin companies took $6.7 billion of U.S. exports, while providing only $3.4 billion in chemical imports. The resulting U.S. trade surplus: $3.2 billion.

The direct investment issue is broader than just total merchandise trade, however. The amounts and uses of direct investment income, fees for the use of the industry's technology, and service and rental charges are also important. For example, major portions of the income from international direct investments are reinvested rather than repatriated. In 1988, 73 percent of the international investment income earned by foreign companies for their chemical FDIUS was reinvested in the United States. That reinvestment was responsible for roughly half the FDIUS increase that year.

It is useful to put the chemical industry's FDIUS into perspective by comparing it to chemical USDIA. Even though the book value of foreign direct investment in the U.S. chemical industry exceeds the book value of U.S. direct investment in foreign chemical industries, chemical industry USDIA investment income receipts continue to exceed FDIUS earnings of foreign parents. In 1988, direct investment income was $6.0 billion, as against payments of $3.0 billion. That figure compares favorably to a surplus of $3.4 billion in 1987, and a total surplus of nearly $13 billion for the five years 1984 through 1988. In fact, USDIA in chemicals earns a much higher rate of return on investment at book value than comparable foreign investment in the United States: 20.8 percent compared to 9.4 percent.

Royalty and license fees paid to U.S. companies during 1988 totalled $1.35 billion. Payments by U.S. subsidiaries to their foreign parent companies for royalty and license fees were only $.43 billion, resulting in a U.S. surplus of nearly $1 billion. Service and rental charges paid to U.S. companies were $.41 billion, service and rental charges paid by U.S. companies were only $.04 billion, yielding a $.37 billion surplus.

In summary, U.S. chemical merchandise trade, direct investment income, and royalties and other fees associated with direct investments brought the industry's 1988 international transactions balance to a $16.6 billion surplus -- and this in an industry considered more "foreign controlled" than other U.S. manufacturing industries. The industry's strong performance did not occur despite its global character and a high level of international direct investment, but because of it.

International investment in the chemical industry is important for several reasons. Such investment allows companies to avoid existing and potential trade barriers. It enables them to better serve large foreign markets, and to meet the specialized needs of their customers. Significantly, by direct investments abroad, the industry gains a hedge against exchange rate fluctuations that can dramatically impact competitiveness compared to foreign producers. Large research and development expenditures are required to develop new chemical products and processes essential to continued international competitiveness. The large sales volumes that can only be provided by global markets are necessary to amortize R&D costs over a broad base. The free flow of international direct investment is critical in maintaining the global production and international competitiveness of the U.S. chemical industry and its strong positive contributions to U.S. international accounts.

FDIUS is only slightly more than one-sixth of total foreign investments in the United States. Stocks, bonds, U.S. government securities and other forms of U.S. obligations make up almost five-sixths of the total. Over one-fourth of U.S. holdings of foreign assets--U.S. investments abroad--is direct investments. U.S. policy discussions should focus not on slowing or restricting the growth of FDIUS, but on the total foreign debt position of the Nation. Macroeconomic policies should be directed toward halting the rapid growth in U.S. debt, while avoiding microeconomic policy restrictions on FDIUS. The goal of U.S. policies should be to lower the cost of U.S. capital, and return to U.S. capital outflows to lending abroad rather than borrowing abroad. In turn, more rapid growth in USDIA should result, but we should expect that FDIUS will also continue to grow as a natural result of continued integration of the world economy.

IV. Conclusion

CMA is convinced that foreign direct investment per se poses little danger to the U.S. economy and that restrictions on FDIUS would reduce U.S. International competitiveness The chemical industry's international direct investments provide positive contributions to the U.S. trade picture, and should continue to be a significant factor in the future. CMA strongly suggests that U.S. economic policy focus on a multilateral approach to achieve international discipline in the investment area, working to remove restrictions that hamper the free movement of capital. We should avoid unilateral actions that would inhibit FDIUS and lower the credibility of U.S. negotiators attempting to lower foreign barriers to direct investment.

Mr. GIBBONS. Thank you, Ms. Johnson.
Mr. Robert Hudson.

STATEMENT OF ROBERT F. HUDSON, JR., CHAIRMAN, TAX SECTION, THE FLORIDA BAR

Mr. HUDSON. Thank you, Mr. Chairman, members of the committee.

The Florida Bar Tax Section is grateful for this opportunity to present its views on U.S. tax policy regarding foreign investment in the United States, particularly as it relates to noninstitutional direct investment. We believe that recent U.S. tax policy in this area has resulted in perceived and actual discrimination against foreign direct investment in the United States, with the result of diverting potential foreign direct investment either towards U.S. portfolio investments or away from the United States totally. We believe that the present system of U.S. income and estate and gift taxation of foreign investors needs to be re-examined to restore fairness and balance to the area.

While a few highly publicized purchases of U.S. real estate by large investors, such as the recent Japanese acquisition of a half-interest in Rockefeller Center, might lead one to believe that foreign direct investment has not been adversely affected by recent tax legislation, we believe that the typical individual or family-based foreign direct investor has been shying away from U.S. direct investment in large part because of the U.S. tax consequences, in favor of attractive investments in Europe, Canada, and elsewhere. U.S. tax policy in this regard can no longer be based on the premise that we are the only game in town.

Moreover, the expense and inconvenience involved in the tax planning required to invest in the United States inhibits broad based—as opposed to large, institutional—foreign investor participation in the U.S. financial markets. This is especially unfortunate in light of the decline in the liquidity of those markets.

It is even more unfortunate that we are considering new barriers to foreign direct investment at a time when there has, as already has been testified this morning, increasing need for the importation of foreign capital.

As the preeminent apostle of free trade in the world, it is ironic that we continue to consider new taxes on foreign persons that are ultimately discriminatory vis-a-vis the taxation of U.S. persons, although they are cloaked in the language of parity and equal footings.

A brief review of the major legislation and administrative developments in this area over the past 24 years, which are detailed in our written submission, demonstrates that we have gone from a tax structure that was designed to encourage foreign investment in the United States to one that is capable of imposing one of the highest combined effective tax rates in the world with the apparent prospects of trying to ensure these maximum effective rates apply to an even broader spectrum of transactions.

In addition, even recognizing that much of our special foreign tax legislation served legitimate policy objectives in the past, changes in other areas of our domestic law, such as the repeal of the *Gener-*

al Utilities doctrine, now cause those provisions to have unfair double or triple tax consequences that were never contemplated by Congress at the time of their enactment.

Furthermore, earnest, but overzealous, Treasury and IRS officials frequently have seized the opportunity to adopt implementing regulations that broaden these original foundations to erect intricate tax webs that fulfill their wider visions of what the tax law ought to be, regardless of whether there is a statutory basis or a negative impact on foreign investment in the United States.

For example, FIRPTA was enacted in 1980 to assure one level of capital gains tax was paid by foreign persons on dispositions of U.S. real estate, either at the corporate level, in the case of foreign corporations, or at the shareholder or corporate level, in case of U.S. companies, but not at both. That objective could now be achieved in the post *General Utilities* repeal era without the special rules for sales of U.S. real property holding companies.

Nonetheless, the May 1988 regulations go out of their way to ensure that foreign shareholders or their buyers will effectively have to pay tax at both the corporate and shareholder level, even though the code explicitly exempts foreign stock from the FIRPTA capital gains tax. Similar criticisms can be leveled at the branch profits tax statute and regulations and the combined effects of the estate tax changes in 1976 and 1988, which now expose foreign persons to rates that are double the pre-1989 level, while continuing to have an exemption of 60,000 that dates back over 35 years. Clearly we have lost any semblance of balance in this area.

Even more troublesome, however, is the continued consideration of a second level of foreign shareholder capital gains tax which will cause more foreign investors to perceive that the United States has become xenophobic and hostile towards foreign investment, thus directing their investments elsewhere. It is difficult to justify the continued tax discrimination applied to foreign investors when compared to the U.S. investors in similar circumstances.

A U.S. investor typically uses subchapter S corporations and limited partnerships to limit personal liability in real estate or other business ventures while paying only the individual income tax rate of 28 percent. The reality is that U.S. persons do not pay two levels of tax on closely-held businesses. Notwithstanding this practical reality of a single level of tax for U.S. persons, we hear phrases like "parity and equal footing" as an excuse for introducing new capital gains tax on foreign shareholders of 10 percent or greater U.S. stock interests.

Such a tax would raise the combined corporate and shareholder effective tax rates to nearly 60 percent, with State taxes frequently taking the rate to over 70 percent. Instead of pursuing such unconscionable and unrealistic tax rates, we believe our policy goal should be to ensure a single level of U.S. tax at either the corporate level or the shareholder partner proprietor level, with no pretense of imposing a U.S. estate tax on intangible interests in those U.S. businesses.

Specifically, certain policy recommendations are set forth in our prepared remarks. We would suggest that by combining those proposals, foreign investors would be able to make U.S. investments in a simple, straightforward manner, without having to resort to complicated foreign structures for U.S. estate tax purposes.

By virtue of these changes, foreign individuals would be able to make U.S. real estate and other direct investments on essentially the same footing as U.S. individuals. We believe the foregoing proposals will restore appropriate balance in U.S. taxation of individual foreign investors.

To those concerned that foreigners are buying up excessive U.S. real estate, we would note the testimony that we have heard suggests that, under the present world economic realities, such large scale purchases by Japanese and European institutional investors will likely continue in any event, but these proposed tax changes will encourage a broader base of individual foreign investment.

That is, broadening the base of foreign ownership by liberalizing the direct investment tax scheme, while retaining the present system of taxation for portfolio investment, mitigates any perceived threat of foreign investment when made in large concentrations by institutional and similar foreign investors. It is also consistent with our historic commitment to the international free enterprise system involving treatment of foreign and domestic investment.

Thus, we ask you not to impede the inbound flows of capital through the introduction of new taxes, but rather to encourage this flow through realistic, fair tax programs that aspire to exact only the single level of income tax which is traditionally paid by U.S. persons on closely held investments.

We thank you for the opportunity to make these views known and hopefully you will give them your full consideration.

[The statement of Mr. Hudson follows:]

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Comments by The Florida Bar Tax Section
Robert F. Hudson, Jr., Chairman
Before the House Ways & Means Committee
Hearing on Current U.S. Tax Policy Toward
Foreign Investment in the United States*
January 24, 1990

The Florida Bar Tax Section is grateful for this opportunity to present its views on U.S. tax policy regarding foreign investment in the United States, particularly as it relates to direct investment. We believe that recent U.S. tax policy in this area has resulted in perceived and actual discrimination against foreign direct investment in the United States, with the result of diverting potential foreign direct investment either towards U.S. portfolio investments or away from the United States totally. We believe that the present system of U.S. income and estate and gift taxation of foreign investors needs to be re-examined to restore fairness and balance to the area.

While a few highly publicized purchases of U.S. real estate by large investors, such as the recent Japanese acquisition of a half-interest in Rockefeller Center, might lead one to believe that foreign direct investment has not been adversely affected by recent tax legislation, we believe that the typical individual or family-based foreign direct investor has been shying away from U.S. direct investment in large part because of the U.S. tax consequences, in favor of attractive investments in Europe and elsewhere. U.S. tax policy in this regard can no longer be based on the premise that we are "the only game in town".

The expense and inconvenience involved in the tax planning required to invest in the United States inhibits broad based (as opposed to large and institutional) investor participation in the U.S. financial markets. This is especially unfortunate in light of the decline in the liquidity of those markets.

OVERVIEW OF DEVELOPMENT OF CURRENT U.S. TAX POLICY TOWARDS FOREIGN DIRECT INVESTMENT IN THE UNITED STATES.

1. Foreign Investors Tax Act of 1966: Creation of the "Level Playing Field".

To gain proper perspective, one must look back to the Foreign Investors Tax Act of 1966, which sought to make certain technical corrections in the way in which the United States then taxed U.S. stock market and other passive U.S. investments by foreigners. Previously, if a foreign taxpayer had any trade or business in the United States, then all U.S. income, whether or not related, was deemed "effectively connected" with that U.S. trade or business and taxed on a net basis under the "force of attraction" principle. The primary thrust of the 1966 legislation was to allow a foreigner to make U.S. stock market investments for his own account without fear of such investments constituting a U.S. trade or business, and, further, to receive capital gains on portfolio and direct investments free of U.S. income tax, even if the foreign investor had an unrelated trade or business in the United States. It was also designed to facilitate investment in the United States through foreign investment companies, and generally to commence the integration of international financial markets by removing tax barriers to cross-border dealings.

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* These comments have been prepared by Jonathan H. Warner, as Chairman of the Federal Tax Division, Joel J. Karp, as Chairman of the National Institute on International Taxation, Dennis Ginsburg, as Chairman of the Foreign Taxation Committee, and Robert F. Hudson, Jr., as Chairman of th Tax Section of the Florida Bar.

The net effect of the 1966 legislation was to level the playing field for foreign investment in the United States. With appropriate planning, either direct or portfolio investment generally could be structured to avoid U.S. capital gains tax.

2. The Tax Reform Act of 1976: U.S. Estate Tax Changes.

The first clear step in favor of portfolio investment and against direct foreign investment in the United States occurred with the 1976 U.S. estate tax reform. Prior to the 1976 Tax Reform Act there was a certain logic and symmetry to the way the U.S. taxed U.S. situs assets on the death of a nondomiciled alien. Only certain assets were taxable and the tax rates and exemptions were roughly half those applied to U.S. domiciliaries. However, the broad liberalizations introduced by the 1976 legislation were restricted to U.S. persons, and one may now characterize U.S. estate and gift tax laws as discriminatory against foreigners. Since that time certain other changes have also been made. See Item 4, below.

For example, while U.S. domiciliaries can take advantage of an estate tax credit of $192,000, foreigners are restricted to a credit of (now) only $13,000 unless an estate tax treaty is available. This disparity, coupled with the Technical and Miscellaneous Revenue Act of 1988's upward revision of the estate tax rates applicable to foreigners to match U.S. rates, results in foreigners being subject to U.S. estate tax on U.S. situs assets at the same rates as U.S. persons, but with only a small fraction of the tax credit available to a U.S. person (other than in certain treaty cases).

Some might view this difference as fair since only certain U.S. property of a foreigner is subject to U.S. estate or gift tax, but that view is cold comfort to a foreign estate having to pay tax on a particular asset on a far different basis than would be paid by a U.S. estate.

This discrimination affects direct investment more than portfolio investment. It is relatively easy to arrange portfolio investments by foreigners so as to avoid U.S. estate and gift tax altogether. On the other hand, subsequent income tax developments explained below effectively penalize direct investment through foreign corporations (which would protect against U.S. estate tax), leaving foreigners to utilize direct ownership or ownership through a U.S. corporation, either of which leaves the foreign investor exposed to U.S. estate tax.

3. Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"): Introduction of Real Estate Capital Gains Tax.

The next step in this evolutionary process was the passage in 1980 of FIRPTA, which for the first time imposed a generally applicable capital gains tax on disposition of U.S. real estate investments by foreigners. FIRPTA was motivated in large part by overblown fears that foreign investors were buying up a disproportionately large share of U.S. real estate, particularly farm land. Ironically, Senator Malcolm Wallop, one of the original sponsors of FIRPTA, became a principal backer of an unsuccessful attempt in 1986 to repeal FIRPTA because farm land prices were depressed. As a result of a multitude of technical problems and unanticipated consequences, the legislation's intent of establishing a level playing field between U.S. and foreign investors in U.S. real estate has been thwarted and foreigners are now at a disadvantage.

4. Deficit Reduction Act of 1984: "Portfolio Interest Bonds".

U.S. tax policy, while never being overly generous to foreign investment, has demonstrated an obvious preference for portfolio over direct investment in dispensing its meager benefits. An example of the developing U.S. preference for portfolio investment by foreigners is reflected in the Deficit Reduction Act of 1984, which introduced an exemption from withholding tax on interest derived from U.S. portfolio debt investments of foreigners. Prior to 1984, U.S. debt issuers avoided the withholding tax for interest on debt capital raised overseas primarily by issuing Eurobonds through the Netherlands Antilles. The 1984 legislation not only opened the door for such debt securities to be floated directly by U.S. issuers, but for the first time allowed the U.S. Treasury to tap large pools of foreign funds. It is significant in this respect that Rep. Gibbons, one of the co-sponsors of the legislation, thought it would assist small issuers (such as real estate developers) in addition to the Fortune 500 companies that dominated the Eurobond market. However, others involved in the tax writing process attempted to prevent small issuers from using the new exemption, and it was not until 1986 that this matter was resolved in favor of small issuers. Note that "portfolio interest obligations" were also made exempt from U.S. estate taxes for foreigners.

5. Repeal of Netherlands Antilles Income Tax Treaty.

In the next few years, the focus changed to attempting through various regulatory measures in legislation to stop utilization of a Netherlands Antilles income tax treaty by third parties. The Antilles Treaty was ultimately terminated in June 1987 by the United States in a rather controversial fashion, with Article VIII of that treaty being reinstated to protect the tax exemption of the large pool of outstanding "Eurobonds" issued by Foreign 500 companies in the United States.

6. Tax Reform Act of 1986: Introduction of "Branch Profits Tax".

The Tax Reform Act of 1986 continued these trends with the introduction of a new 30% branch profits tax on foreign corporations doing business in the United States. The proponents of this tax maintained that prior law favored foreign corporations over domestic corporations as vehicles for foreign direct investment in the United States, and that shareholder level taxation might be deferred or avoided through the mechanical rules determining taxability of dividends paid by foreign corporations. The 1986 Tax Reform Act largely has done away with the old dividend withholding system for foreign corporations operating in the United States, and instead has imposed a 30% direct tax on the foreign corporation itself. Thus, unlike domestic corporations, a foreign corporation operating in the United States will pay two taxes, the corporate income tax, and a tax of 30% (or lower treaty rate) on its post-tax earnings and profits, raising the foreign corporate tax rate from the maximum domestic rate of 34% to 53.8%.

The introduction of the branch profits tax was not based on significant revenue considerations, the initial revenue estimate showing collections of only up to $37,000,000 per year by 1990.

The alleged motivation instead was a search for symmetry in the U.S. tax treatment of U.S. branches compared to subsidiaries. However, as noted in comments on the branch profits tax filed at the time by The Florida Bar Tax Section, the impact of this tax has been to favor U.S. corporations over foreign vehicles since a U.S. corporation now can more easily control when shareholder level taxation will occur. Many foreign corporations are being required to pay branch profits tax on an annual basis, whereas the U.S. corporation (although theoretically subject to accumulated earnings tax) may be able to defer the corresponding shareholder level tax. More discouraging to foreign investors, however, is the complication wrought by this new, essentially untried, form of taxation. Compliance costs have significantly reduced the already low relative rates of reform.

7. Revenue Act of 1987: Failed Attempt at Introduction of New Second Level Tax.

It is noteworthy that the Internal Revenue Service responded to charges that the branch profits tax as enacted went too far by issuing an announcement that pending regulations would exempt a U.S. branch of a foreign corporation from the branch profits tax in the year that it terminated its U.S. investments. That announcement had the beneficial effect of restoring some balance between U.S. taxation of such investments through U.S. corporation (which can be liquidated at the cost of only the corporate level of taxation) and foreign corporations. However, during consideration of the 1987 Revenue Act, the Joint Committee evidenced an intent to overrule the IRS announcement through language in a draft Committee Report in connection with proposals involving wholly unrelated domestic issues (i.e., the anti-"mirror transaction" rules). This attempt failed, but was resurrected in 1989, as detailed below. In the meantime, the Temporary Regulations implementing the branch profits tax have been criticized as failing to meet the promise of the initial announcement on this point.

8. Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"): Doubling of Estate Tax Rates on Foreigners.

As mentioned above, the U.S. estate and gift taxation of foreigners had been deemed by many discriminatory and unfair since the 1976 liberalization of U.S. estate tax treatment of U.S. persons, most of the benefits of which were denied to foreigners. Apparently without any consideration of the equities involved, TAMRA included a measure effectively doubling the U.S. estate tax rates of foreigners, making them identical to U.S. taxpayer rates without correspondingly increasing the credit.

As with other changes noted above, revenue generation was not a major factor in this legislative change, since Treasury data shows that U.S. estate tax collections from foreigners in recent years was at approximately the $4,000,000 level. Doubling the rates thus should not yield significant additional revenue in this area, but the impact on a taxable foreign estate can be significant as a "trap for the unwary".

9. Revenue Reconciliation Act of 1989: Another Failed Attempt to Impose Second Level Tax.

The House version of the 1989 tax legislation included a provision seeking to impose a second level tax on dispositions of stock by foreigners in U.S. corporations. Once again, portfolio investment was favored over direct investment through a proposed exemption for most stock market investments, leaving the tax to apply primarily to foreign direct investment through U.S. companies. We believe that this proposal was properly rejected by the Joint Committee, but the proposal itself reiterated the message that U.S. tax policy now seeks to discourage foreign direct investment in the United States.

In summary, tax legislation since 1976 has destroyed the prior balance between U.S. tax treatment of portfolio and direct investment in the United States by foreigners. A foreigner can invest in U.S. equity and debt securities without tax on capital gains and without tax on interest generated by portfolio and certain other obligations. Because these types of investments can easily be arranged through a foreign holding company, a passive investor is generally unconcerned about U.S. estate taxation, and branch profits tax does not apply because the foreign corporation's investment is not treated as a U.S. trade or business. Thus, present U.S. tax policy makes passive U.S. investment by foreigners effectively free of U.S. tax, except for withholding tax on dividends.

By contrast, a foreign investor desiring to purchase U.S. real estate or other direct interest in a U.S. business enterprise is faced with an array of U.S. income tax and estate and gift tax hurdles that substantially inhibit the desirability of investing in the United States. If that investor chooses to invest personally, he will be subject to U.S. estate tax on the value of the underlying asset, with only a fraction of the credit available to U.S. persons unless an appropriate treaty applies. If the foreigner instead chooses to acquire the U.S. asset through a foreign corporation to protect against the estate tax, then the investor will be denied the favorable 28% income tax rate available to U.S. individuals, and the investment instead will become subject to U.S. tax rates as high as 53.8% because of the interaction of the corporate income tax and branch profits tax.

Clearly, we have lost any semblance of balance in this area. Even more troublesome, however, is that the continued efforts of some involved in the tax legislative process to exact a second level tax on foreign investment may cause more foreign investors to perceive that the United States has become xenophobic and hostile towards foreign investment, thus directing their interest elsewhere. It is difficult to justify the continued tax discrimination applied to foreign investors when compared to U.S. investors in similar circumstances. A U.S. investor generally is able to use S corporations or limited partnerships to limit personal liability in real estate or other business ventures, while paying only the individual income tax rate of 28% because of the pass-through nature afforded such vehicles for U.S. tax purposes. On the other hand, a foreign investor considering a similar U.S. real estate or other direct investment faces the following problems:

(a) Since a nonresident alien cannot be a shareholder in an S corporation, using a U.S. corporation for the investment will cause the U.S. 34% corporate tax rate to apply, and still leave the investor subject to U.S. estate tax on the stock of the U.S. corporation unless a foreign holding company is utilized. Under present law, this choice at least leaves the investor with the potential to eventually liquidate the investment without tax at the shareholder level on the liquidating capital gain, but repeated legislative attempts at second-level taxation in these circumstances should give pause to foreign investors considering this alternative.

(b) Utilizing a foreign corporation for the investment will cause not only the U.S. corporate tax of 34% to apply, but the branch profits tax of 30% as well, thus raising the potential U.S. tax burden to 53.8% This option, however, affords protection from U.S. estate tax.

(c) In order to achieve the 28% individual tax rate available for U.S. persons, the foreign investor will have to invest through a partnership or other non-corporate vehicle, which generally leaves him at risk for U.S. estate taxes on the investment.

POLICY RECOMMENDATIONS

We believe that the principal issues that need to be addressed to restore balance and fairness in U.S. taxation of foreign investors are threefold:

(i) Simplification and revision of the U.S. estate, gift and generation-skipping tax system applicable to foreign domiciliaries;

(ii) Repeal or substantial revision of the branch profits tax; and

(iii) Creation of a new pass-through corporate vehicle to allow foreign investors to make U.S. investments in a manner similar to U.S. persons utilizing an S corporation, while affording estate tax protection.

A crucial consideration in connection with these proposals is that neither the current U.S. estate and gift tax on foreigners nor the branch profits tax are defensible as significant revenue measures. As noted above, the revenue potential of these proposals has been relatively small. Instead, at least in the case of the branch profits tax, the driving force behind enactment was an attempt to create an alleged balance between utilizing U.S. branches or subsidiaries for investment in the United States. On the other hand, there has not been even a theoretical justification given for the estate tax differential created by the 1976 and 1988 legislative changes.

We believe that the Treasury's background proposal for the branch profits tax missed the mark in focusing narrowly on the distinction between investing in a U.S. branch of a foreign corporation compared to investing in a U.S. subsidiary. Granted, there were technical differences between these alternatives that could have been perceived as causing foreigners to choose foreign corporations instead of U.S. corporations for U.S. tax reasons. However, foreign investors contemplating a direct investment in the United States must consider a great number of U.S. and foreign tax issues, as well as other factors, in making the basic choice of an investment vehicle. Many of these factors have nothing to do with the disparity cited by the Tax Reform Act of 1986 Committee Reports in the treatment of after-tax earnings of a branch as compared to a subsidiary. What the Committee Reports ignored is that the increase in the U.S. tax burden through the branch level tax serves to divert proposed U.S. investment to other countries or into portfolio investment. Such diversions contravene the Act's premise of tax neutrality.

The Committee Reports also ignored the fact that foreign investors that choose to invest through a U.S. branch forego other, substantial U.S. tax benefits, such as the ability to utilize a consolidated return. In comments at that time, The Florida Bar Tax Section pointed out that it was inappropriate to focus only on a narrow comparison of the treatment of post-tax earnings of branches versus subsidiaries when reviewing the tax burden of the foreign investors in the United States. Further, the enactment of the branch profits tax now requires special computations and additional record-keeping, thus imposing a new and unique burden on foreign corporations doing business in the United States, in contradiction of the simplification objectives of the 1986 Act.

The Florida Bar Tax Section has also previously submitted to Treasury a proposed revision of the U.S. estate and gift taxation of non-domiciled aliens, which we believe would simplify and make more fair the U.S. estate and gift tax treatment of nonresidents. This proposal in essence would treat nonresidents like U.S. domiciliaries by providing for the same rates and the same credits and deductions for taxable U.S. property. The proposal would also remove U.S. corporate stock from the estate tax base. Given the historically low level of collections of U.S. estate tax on nonresident aliens, it is believed that this proposal would have little net revenue loss.

By combining the above proposals, we believe that it would be appropriate for the U.S. tax system to allow an individual foreign investor to make a direct investment in the United States through an otherwise qualified S corporation, without the stock of such corporation being subject to U.S. estate taxes at the death of the alien shareholder. This would allow individual foreign investors to make simple U.S. investments in an expedient manner, without having to resort to tax havens to form foreign holding companies for U.S. estate tax purposes. By virtue of this change, a foreign individual would be able to make a U.S. real estate or other direct investment virtually on the same footing as a U.S. individual at least as far as U.S. income tax rates are concerned.

We believe that the foregoing proposals will restore an appropriate balance in U.S. taxation of individual foreign investors. To those concerned about media hype that foreigners are buying up U.S. real estate, we would point out that large-scale purchases by Japanese and European corporations or institutional investors will continue without these proposed changes, which are directed primarily at the small individual or family-based foreign investor. We believe that the real estate and other direct investment made in the United States by these types of investors are beneficial, having historically been encouraged by U.S. policy (tax or otherwise), and should not be discriminated against as is the case under present tax law.

Broadening the base of foreign ownership by liberalizing the direct investment tax scheme, while retaining the present system of taxation of portfolio investment, mitigates any perceived threat of foreign investment when made in large concentrations by institutional and similar foreign investors. It is also consistent with our historic commitment to the international free enterprise system involving equal treatment of foreign and domestic investment all over the world.

We thank you for the opportunity to make our views known and hope that you will give them your full consideration.

Mr. Gibbons. Thank you.

I want to thank every member of the panel for your excellent testimony. It is very factual and persuasive.

Mr. Hudson, I have been spending the last week in Canada. I am just here today for this hearing.

I am up there with my constituents who are trying to help implement the free-trade agreement. They are up there to see if they can buy something or sell something.

I notice from talking to Canadians that there are other local delegations coming from the United States having meetings with law firms or accounting firms, investors and banks.

We even hold seminars in various cities for potential business up there. I am up there huckstering a little, I guess.

It doesn't violate the conflict of interest laws here in the Congress, I am glad to say. I got it all cleared with the Ethics Committee.

You have to do those things like that before you can breathe around here now.

One of the things I ran into—and I don't know whether you ran into it or not—is that somehow between the Canadian and the United States tax authorities, we so screwed up the tax laws on foreign investment in the United States that all Canadian lawyers—many of whom own homes ~~in Florida~~—are advising their clients to dump their Florida investments because they sometimes get a nearly 90 or 100 percent tax rate on everything. It draws them into our income tax laws income—I mean estate tax law. Between the Canadian income tax laws and our income tax laws, there is nothing left.

They are getting out. Where are they going to go? They are going to go to Cuba and rent a place, I guess, or they will go all through the Caribbean where they don't get manhandled.

Nobody gains from that.

We make a lot of money out of handling those nice people there. Six hundred thousand of them come to the United States every year, 400,000 just to Florida alone. So we are talking about a serious problem.

Have you run into that in your law practice?

Mr. Hudson. Absolutely, sir. What we see constantly is Canadians finding, when they learn the new tax reality is effective tax rates for estate tax purposes of up to 55 percent on the entire value, they are selling out because there are not legitimate structures that we can provide that won't either screw them on the Canadian side or the U.S. side.

So they are saying, we will just cut it out. It is a very real problem, particularly in Florida.

Mr. Gibbons. I have asked the staff here to pay some attention to it. They say they are going to work with Treasury and getting something worked out with the Canadians on that.

Nobody would levy on industry the kind of taxation we now have on these people.

We are practically confiscating their property the way it works. Here we have entered into a free-trade arrangement with them, and they are our best friends and we sure have gyped them on their investments, some of which go back 40, 50 years.

Mr. GUARINI. Mr. Chairman, just a point of note. Is it the Canadian laws?

Mr. GIBBONS. A combination of Canadian and United States laws.

Mr. GUARINI. The foreigners don't pay any more tax under FIRPTA. FIRPTA is just a reporting procedure, as I understand it.

They don't pay any more capital gains tax than the American citizens do. We treat them alike. We track them with FIRPTA to make sure they don't get out from underneath.

Mr. HUDSON. The problem is our estate taxes now. This is a lack of symmetry between the United States and Canadian estate tax systems.

We have effective rates now of 55 percent. If we give them a $60,000 exemption, our own people get a $600,000 exemption, numerous techniques to reduce the effective rates, none of those techniques are available to the Canadians.

You are talking of wealthy older people. The estate taxes are a real concern to them.

Mr. GUARINI. That is a result of something that is wrong with our own laws in this country. It is something wrong with the tax treaty between the United States and Canada.

Mr. HUDSON. We just almost doubled the rate from a maximum 30 to 55 percent in 1988, projecting it would raise all of $4 million with no apparent policy decisions. This parity sort of gets wielded around without any concern of what it does.

Mr. GUARINI. Do you have any complaints with FIRPTA?

Mr. HUDSON. It is double taxation. We fully accepted FIRPTA's single tax goal. It was fine.

But, it has been extended and exaggerated clearly and explicitly by Treasury to force two levels of taxation where it was designed to cause one. Often the impact is on U.S. people.

We testified before the Treasury hearing about a year ago. If U.S. persons now buy U.S. companies from foreign people, we have to pay two levels, theoretically maybe even three levels of tax, whereas the foreigners only still have to sometimes pay two.

Actually it not only goes after double taxation of foreigners, but can result in triple taxation of U.S. people. As applied, it has ended up quite excessive.

Mr. GUARINI. Don't they have advantages in certain ways?

Take the house in Florida. Suppose someone in Canada filed a Florida corporation and bought the house in the corporation and then wanted to use the house as their summer home, winter home, whatever it may be, and they went to sell the house. All they do is trade their shares of stock up in Toronto, and the United States won't have any way of tracking the owner of the shares or the payment of taxes.

Don't they get away with certain ball games?

Mr. HUDSON. No, sir; the FIRPTA withholding tax provision sponsored by Representative Gibbons has effectively served to cause buyers of any U.S. stock shares in a real property holding company or any U.S. real estate to withhold 10 percent of the gross purchase price. That is a requirement taken very seriously.

FIRPTA withholding has collected tax amounts that are tenfold what was originally projected. It is very effective. Those games no longer go on, sir.

Mr. Guarini. If someone is going to use the house themselves, not going to rent the house and there is no income from the house, then once the shares are put in a corporation, they can go trade in those shares of stock and have multiple loaners in future years without any reporting requirements on the part of the United States and without their paying any taxes or being responsible for any gains they created.

Mr. Hudson. I would respectfully suggest that no legitimate real estate or professional tax adviser that I know of would ever be party to the transfer——

Mr. Guarini. All you have to do is sit in Zurich and say here is the shares of stock in X corporation, and I am going to transfer it to you.

Nobody in our country would have any idea what happened. They can get away with an awful lot, too.

There are two ways that this cuts.

Mr. Hudson. A legitimate tax lawyer is not aware of that.

Mr. Gibbons. You mean to tell me I can put my real estate in the name of a corporation and slide the shares around and never get caught by the IRS?

Mr. Guarini. You could not as a citizen of this country. But if a person is offshore, there would be no way of any record being kept of who the successor shareholders were.

Mr. Gibbons. I could put my shares in a trust over in the Bahamas and I could move it around?

Mr. Guarini. Yes, sir; there is no doubt about that. That is happening all the time, I would suspect.

In your tax experience, have you heard of this, in all frankness?

Mr. Hudson. No; As a practical reality it doesn't happen.

Mr. Guarini. Why?

Mr. Hudson. People don't want to deal with shareholders because of the undisclosed liability problem. It is a standard technique that people actually want to own the underlying hard real estate.

People won't buy shares. There is intrafamily gifts, but we don't impose a gift tax on gifts of shares, be it United States or foreign. But, a new buyer, I don't care.

We deal with Latin Americans, Europeans, Middle East. They don't want to buy the shares.

They know they are buying inherent built in gain taxes if they buy shares, and they want big discounts that basically force the taxation really on the seller.

Mr. Guarini. I should imagine there are ways they can get assurances over a certain period of years or putting money in escrow.

Mr. Gibbons. Frank, I met you too late in life. I wish I had met you years ago. I spent it all is the trouble.

Mr. Crane. I am astounded at Frank's understanding of this.

Mr. Guarini. I got s-h-r-e-d when I joined the Ways and Means Committee.

Mr. Gibbons. You were shred long before you came here.

Mr. Crane. I want to congratulate all the witnesses and concur in their sentiments. I had the privilege of visiting Japan in 1981 with the American Productivity Center.

One of the things we all kept getting hit with after we had interrogated the CEO's and presidents of the corporations was that in labor management relations, what they were doing came out of pioneer studies at the University of Iowa in the 1950's.

They learned how to provide incentives for capital formation and savings because of counsel from economists at the University of Chicago.

They learned technology from us and almost plaintively said you people invented robots. Why haven't you robotized.

I think foreign investment in this country is a compliment to the United States.

The concern I want to raise is with developments that are going on in Eastern Europe since you make investment based on what you anticipate a very attractive return, how great a threat is this since there is yet to be a limit of the amount to invest worldwide?

How great is that to our economy, assuming that these developments continue in a positive way, in the decade we are entering? It seems to me we could be up against some awesome competition in people starting to divert resources.

Mr. BERGSTEN. I would not expect in the aggregate a large flow of capital into Eastern Europe itself until those countries are several years further along in their reform process. However, I think your basic point is correct. If you look at the combination of Western and Eastern Europe and its prospects through the decade of the 1990's, there is a competitive threat.

I think Western Europe is going to achieve a unified economy over the next 5 to 10 years, not just completing the 1992 process to reduce trade barriers but coming to a common economic and monetary policy. There is a blueprint for that, and they will start negotiation on it by the end of this year.

My guess is that the drive toward unification is going to succeed in large part over the course of the 1990's.

We already see an anticipation of that in the markets. A great deal of investment generated within Europe that otherwise would have come here is staying home, and capital from around the world is starting to go into Europe, anticipating its becoming a new, dynamic factor in the world economy.

We often get caught up in our discussions of how the United States has been the big magnet for investment around the world in the 1980's. We got hooked on foreign capital in those years, and lucky for us it came in. That has not been a long-term phenomenon. In the 1960's the bulk of international capital flows went into Europe. When Europe formed the Common Market and enjoyed rapid growth and a lot of immigration, with workers coming in from southern Europe, Europe was the attractor of international investment, including investment from the United States. In the 1970's, in the wake of the oil shock, international capital went into Latin America, for reasons that now don't look so good.

The United States became the magnet in the 1980's. My guess is that we are going to have a lot of competition for that magnetism in the 1990's, and a great deal of it will be from Europe.

If that happens, in order to attract the capital we need to keep financing our huge deficits we will have to have even higher interest rates or do other things to keep the money coming. As long as we need it, we have to get it one way or another. Therefore I think you put your finger on a real problem. I think it adds further to the need for us to get our house in order.

Mr. **Crane**. I concur wholeheartedly that we are talking about symptoms of a bigger problem. That is our failure to address properly our budget deficit.

We ought to proceed with a greater sense of urgency on that looking down the road to some of these new developments.

I want to thank you all for your participation and your testimony.

Chairman **Rostenkowski**. Mr. Levin.

Mr. **Levin**. Thank you.

As others, we welcome your testimony. I think we need to take another look at the Tax Code. Let me, if I might, though, skip to Fred Bergsten for just a moment.

I think that the issue is not whether we are hooked—that, we clearly are. But, whether we distorted by this imbalance—here you give at best very mixed signals.

You congratulated Mr. Bryant on his reference to sovereignty, but then oppose his bill. Even more so, I think, is the way this issue of possible distortions of direct investment is handled in the book, in the foreign direct investment book that the institute put out.

It acknowledges that there is a much higher import propensity among firms that are foreign owned. It talks about a 2½ times differential.

We should never forget that that makes it six times. We are not talking about 2½ times beyond domestic firms. We are talking six times beyond the domestic firm, the Japanese-owned foreign firm.

But then it seems to me that the language and in a sense the body language is kind of a shrug. That is even true in your testimony. You say we have to clearly look at it, but there is no big effect.

When you tell that to anybody in government, there will be no clear look. If the effect is going to be small, the response is going to be, "So what?"

I think that the authors have to understand that. Even in the choice of language on page 56 it says, "The raw facts do support the stereotype that foreign firms import more. And our guess is even if all plausible corrections were made, the qualitative fact would remain."

The use of the word "stereotype" is very interesting. What it means when you utilize that word, we imply it is there is something basically wrong with it. It is not a fact, but it is a stereotype.

Then the book concludes:

> The only discernable difference is a higher propensity to import which may represent a difference in behavior, but may instead reap a selection bias in the activities in which foreign firms engage.

But then it says—

> In any effect, it is a small difference.

Let me just ask you to try to say it straight out. No. 1, is it something that we ought to worry about?

No. 2, when the authors looked at the impact, they did not, for example, look at whether the foreign firms that are here affect purchases from American-owned suppliers in the United States. The transplants have bought with them other companies.

I don't know of reference at all to that. Is that a matter we ought to be concerned with?

Last—and you won't have much time to answer it—do you think it matters at all who owns what in America?

Mr. **Bergsten**. My answers roughly are yes, yes, and yes.

Mr. **Levin**. It does matter who owns what?

Mr. **Bergsten**. Yes. We worry about the high import propensity. In my comments I underlined the fact that that ratio was 6 to 1.

Mr. **Levin**. Then you say there is no big effect. That is what you said.

Mr. **Bergsten**. We don't think there is a big effect on the trade balance or the economy as a whole. Even though it doesn't look big to us, I said, and the book says, it is something we should watch carefully.

I also made the comment, which you did not note, that this may be a temporary phenomenon. As American firms go abroad to invest in other countries, they tend at the outset to bring a lot of goods from the United States; capital equipment to set up the new plants, inputs from their own factories and suppliers they are familiar with in the United States. Over time they become more enmeshed in the local economy, and the local contents rise.

The same thing may happen for the foreign-based firms here, particularly the Japanese, who start out by bringing suppliers with them or importing products from Japan. The life cycle of foreign investment historically suggests that firms tend to enmesh themselves in the local economy, and those ratios go down over time, as indicated by the fact that the Japanese ratio is 2½ times that of other foreign-based firms here, most of which have been here longer.

We don't jump to an immediate policy conclusion and call for legislation of local content rules because we are not sure that this is not a transitory phenomenon that will play through as other direct investment around the world has. We say we should look at it, keep it monitored, but if it is small, maybe one shouldn't take policy action. We say keep it under review and see if it doesn't begin to improve. Take another look at this year-by-year, and see if those ratios improve. If they don't, then you might want to take action.

The answer to your question as to whether it matters who owns what is "yes." I underlined in my statement, as I have every time I come before this committee, that we should not have put ourselves in a box where we have to sell off the country to finance American consumption. In the 1960's we worried about losing gold from Fort Knox. Under fixed exchange rates, when a country ran a trade deficit it had to sell assets to finance it, and so we sold gold from Fort Knox. And everybody got excited about that.

We changed the system. Now we don't sell gold from Fort Knox. Instead we sell companies, real estate and the like. I think it is a bad thing. That is why I have been imploring this committee and the country to get rid of these deficits. As long as we don't, we are going to continue selling off part of the country.

Mr. **Levin**. It is just not clear. As long as they stay, as long as there are cyclical trends, so what if we sell off part of the country? What does it matter?

Mr. **Bergsten**. If it were a cyclical trend, I think we would be seeing some change in the cycle by now.

Mr. **Levin**. You said with the 1960's and the 1970's.

Mr. **Bergsten**. In the 1980's this has gone on for 7 years. The best projections we make and that others make is that the trade deficit is going to be rising, and by 1992 it may be over $200 billion. The borrowing requirements will therefore increase. It doesn't look very cyclical. As a long-run proposition, we live in a growingly independent world economy. We are becoming more dependent on external events.

Our study asked how foreign control in America stacks up against foreign control in other countries around the world. The conclusion was that, with the big exception of Japan, the extent of foreign control in the United States is much lower than in the other major industrial countries. In the European countries, foreign direct investors own on average something like 20 percent of output.

Here the number has risen rapidly and is now about 10 percent, about half that in the European countries. We project, as a wild guess, that that number will continue to rise but will not get as high as Europe's 20 percent, but may level off at 15 percent. It will continue to rise but at a tapering rate. This assumes that we stop this need to borrow $10 to $15 billion a month from the rest of the world. To do otherwise will shoot the number up, up, and up.

Mr. **Gibbons**. Mr. Levin, the red light is on. I hate to interrupt you.

Mr. Chairman.

Chairman **Rostenkowski**. No questions.

Mr. **Gibbons**. Let me announce to the members that are here and the audience that we plan to work right on through the lunch hour if that is agreeable to everyone. Is that agreeable? Fine.

Mrs. Johnson.

Mrs. **Johnson** of Connecticut. Thank you, Mr. Chairman.

Briefly to follow up on my colleague from Michigan's questions. I was struck, Mr. Bergsten, by your comment, your data about input disparity and yet, your confidence in the data collection capacity in America, your belief that there is no need for a legislation of the type that Representative Bryant recommends.

First of all, how can you have such confidence in your input figures, recognizing that they are extreme, a 6-to-1 disparity? Yet, when we asked the GAO to study the same thing, they could not get information about inputs from the Japanese companies. So, there is a lot that we don't know about where component parts are coming from. That would, to me, say whatever data is out there is understating the problem. That is one issue.

Second, in your book for instance, you say on page 56, there remains a classification problem that many foreign firms are both marketing in distribution firms and manufacturing firms, and we classify them one way or another.

If we classify them as marketing and distribution, they don't get classified as manufacturing. That would significantly distort the data you are working from and understate the data you are working with regard to manufacturing. If you don't think we need legislation, as Congressman Bryant is recommending, certainly we need some refinements and reforms. I would like you to be a little more specific as to what you think we do need and what you think the implications might be from the data if we need better information.

Mr. **Bergsten**. I think the answer to your two questions is really the same.

Those 6-to-1 or 3-to-1 ratios were for manufacturing as a whole. I suspect that when you talked to the GAO you were asking for a specific sector.

Mrs. **Johnson** of Connecticut. Just auto parts.

Mr. **Bergsten**. Right. We didn't try to calculate it at the sector-specific level. I think you are quite right. There the data would be much harder to come by, because of the misclassification problem among others. We were looking for an aggregate. Even there, there could be problems. We biased all our estimates in a conservative direction.

I feel our numbers are in the ballpark. I would not live or die over 6-to-1 versus 7.2-to-1. What we are trying to show is the order of magnitude of the difference. I think the point was made.

As I said in my earlier comment on Congressman Bryant's proposal, I am all for better data. In our book we flag the need for improvement in the data in a number of regards, including on this classification question. It doesn't require new legislation, however. What it requires, as we say in the book, is that data collected at the establishment level, of the type now generated by the Census Bureau, be put together in that form. Those raw data are available. They are simply not compiled in that way. That may take more resources.

Mrs. **Johnson** of Connecticut. I would be very interested in any ability that you have to provide data on manufacturing, on certain sectors of the manufacturing economy in regard to inputs. When you have that kind of disparity on where you are getting component parts and it carries over into the after market of spare parts, then that has very serious implications for your industrial base, for the bearing industry.

If in fact in certain sectors this in not a 6-to-1 ratio, but a 1-to-2 ratio, we need to know it. Do we have the ability now to look at that? Do we have the information out there at this time to look at that kind of thing?

Mr. **Bergsten**. Well, the authors of the study—and one of them was zealously pursuing the data question—do indicate that raw data already being collected by the Census Bureau make a compilation of the data at the establishment level such as you suggest a technical possibility. They also mention that the BEA itself does not collect such data but could begin doing so. It has made a beginning with its 1987 benchmark survey.

Mrs. **Johnson** of Connecticut. I assume from your answer that your answer to my question is no, we don't have the ability on a sector——

Mr. **Bergsten**. No; the answer is that there are raw data available. We do, therefore, have the ability. It is not compiled in the way you and I are both saying would be desirable. There is a need for much greater disaggregation and a much more careful industry classification of the data.

We ran into that problem in the book for the reason indicated here. A Japanese auto company that started out doing a lot of wholesaling of its product through distribution channels is still in some cases shown as a distribution company rather than a manufacturing company.

The point is that I don't think we need new legislation, but we do need to make better use of existing data and in some cases under existing authority to collect more and compile it differently and analyze it in a more intense way.

Mrs. **Johnson** of Connecticut. Thank you, Mr. Chairman.

Mr. **Gibbons**. In other words, it is just a bureaucratic problem.

Mr. **Bergsten**. There are some bureaucratic problems between the Census Bureau and the BEA. As always, there are budgetary problems in terms of their having enough money and people to do some of these things. What are the priorities? What are they going to spend their working days doing? But I have the sense that with existing data one could do a lot more than is now done. If you want more data collected, there is plenty of authority to go out and collect it.

To be clear to Mr. Levin, I do not oppose Mr. Bryant's amendment. I said I do not think it is necessary. I don't have a strong view, to tell you the truth. I don't view Mr. Bryant's amendment basically as a data collection amendment. I view it as a disclosure amendment. I think he is asking that data that are now available be made more widely available.

A lot of the data are now available to the technicians who are putting the statistics together. For reasons of confidentiality of company data they are not made available more broadly to you, me, or anybody else. I think what Mr. Bryant is asking is for more of that to be done. There is a question of whether making the data more widely available would hurt its credibility because firms would be a little more leery about reporting it, or whether you actually get something out of the process.

A related question is whether there ought to be differential treatment of privately held firms that are foreign versus privately held firms that are American. Such discrimination would, I think, be called for under his amendment.

I don't think it is basically a data collection issue. I think it goes to disclosure and the principle of discrimination between U.S. and foreign-based companies purely on that basis.

Mr. **Gibbons**. This legislation does not give national treatment, as I understand it?

Mr. **Bergsten**. That is right. It would require more data disclosure by foreign-based firms than by U.S. firms that are privately held. Foreign firms whose stock is traded on the stock exchanges already have to file the same 10K's under the SEC rules as do American companies. The issue is what to do about privately held firms that are not traded and therefore don't have to file SEC 10K's.

Congressman Byrant's legislation would require foreign-based firms in that category to disclose whereas U.S.-based firms would continue not to have to, as I understand it.

Mr. **Levin**. We have been through this for 4 years in the auto parts area. If the question of ownership has some relevance, and you say it does, if you don't ask questions about who owns what and have the information, you don't know what to do. It seems to me inconsistent or somewhat unconcerned in attitude to say let's not—the trend could be dangerous, but let's not find out what the trend is.

Mr. **Bergsten**. With all due respect, I am not saying that. In response to Mrs. Johnson, I said bring in the BEA and the Census, have them tell you exactly what they can do with existing data, and what authority they may need to get more.

I think if you did that there is a strong possibility that you would be able to get a long way down the road without any legislation, and therefore much more quickly.

Mr. **Levin**. You are not objecting to asking questions regarding ownership of firms?

Mr. **Bergsten**. To the contrary. In the data section of our study we suggest getting better and more extensive data on all those issues.

Mr. **Levin**. It differentiates as to ownership?

Mr. **Bergsten**. Right.

Mr. **Gibbons**. Other questions?

Thank you very much.

Excuse me.

Mr. Guarini.

Mr. **Guarini**. I just want to ask one last thing.

Some years ago we had a law that foreigners could invest in real estate and not pay any capital gains tax whatsoever if they stayed here less than 6 months.

Mr. **Gibbons**. Mr. Hudson and I cured that.

Mr. **Guarini**. Yes. Now they pay capital gains tax on real estate. Some years ago we had no withholding tax on bonds and investments.

I am sorry; we had withholding tax some years ago of 30 percent on bonds and investment. Now we have no withholding tax. We seem to have reversed our position in real estate and bonds and investments where we let one off tax free.

Now we are taxing, which is doing vice versa. Does that make sense to you?

Is that a consistent policy? Have you got any thoughts on that?

Mr. **Hudson**. Yes, sir.

A good portion of our submitted remarks address the fact that portfolio investment is much more highly favored than direct investment.

Frankly, direct investment moves—I will leave it to the economist to tell you better than I—but moves much more slowly than portfolio which can cause a 77-point drop in the market that day.

When people invest millions of dollars in plants and equipment here, they can't pull that out the next day. To us it seems, frankly, our priorities have gotten a little askew.

If anything, we ought to be encouraging the direct investment rather than simply the portfolio that can be pulled out on a whim.

Also I would note that while we are not espousing a return to tax exempt real estate capital gains; a single level of tax, we think, was wholly appropriate.

I think most clients we see are not bothered by a single level of tax. But they are bothered by the proposal passed by this committee at the end of last year that would have introduced a new second-level shareholders capital gains tax which would have brought that effective rate up from 34 percent to nearly 60 percent because it would have no longer been possible to liquidate the former U.S. real estate holding company tax free which is possible today and you only pay the one corporate level.

We object to the two-level tax system contemplated by Code section 899 considered last year.

Mr. GUARINI. Can foreign corporations elect subchapter S?

Mr. HUDSON. They cannot; in our written submission, there is a written proposal to amend the tax laws to enable foreign persons to do so and couple it with a withholding tax provision of the type that was passed 2 years ago, partnership withholding under 1446 which basically assures that foreign partners will pay their tax on U.S.-trade or business profits.

We submit the same thing can be done with a corporate-type subchapter S vehicle.

Mr. GUARINI. In order that the steel worker in Gary, IN, doesn't have to subsidize large foreign investment corporations, do you think we should put back our withholding tax? Ought not we make sure as we tax real estate now, that there be tax withholding?

Mr. HUDSON. That withholding tax is a secondary tax. The company that is paying that interest is already paying income tax. If you introduce the withholding tax on portfolio bonds or so-called Eurobonds, frankly, you are just going to drive that market array again.

Mr. GIBBONS. You are going to run interest rates up?

Mr. HUDSON. Exactly.

Mr. GIBBONS. If you want to pay higher interest rates, you do that.

Mr. GUARINI. The other side of the coin is the working man in American will subsidize these people who don't have to pay the tax?

Mr. HUDSON. I submit that withholding tax will ultimately come to bear on the U.S. businesses that have to pay for that capital because the foreign markets are going to be able to get equivalent interest rates without the tax in other markets, Japan included, even when you add the tax. It basically gets grossed up and gets passed back to the debtor.

It just makes us cost more.

Mr. GUARINI. Thank you.

Mr. GIBBONS. Thank you very much.

Now our final panel—Citizens for a Sound Economy, Nancy L. Oliver; International Trade Council, Peter Nelsen and Gail Pfister; the U.S. National Committee for Pacific Economic Cooperation, Alexander Good; and the California State World Trade Commission, Mr. Walker.

We appreciate the long time you have waited. I can see attrition is taking its toll up here, too. If we can just get right to the point.

Ms. Oliver, we will go to you first.

STATEMENT OF NANCY L. OLIVER, DIRECTOR OF TRADE POLICY, CITIZENS FOR A SOUND ECONOMY

Ms. OLIVER. My name is Nancy Oliver, and I am director of trade policy at Citizens for a Sound Economy—a nonpartisan public policy group dedicated to solving pressing national problems in ways that promote economic growth and opportunity. I am glad to have the opportunity to appear before you because CSE's 250,000 members share with all Americans a vital interest in the country's economic future.

I am here today because CSE is committed to promoting the free flow of capital.

Foreign investment is not a new issue. In the 1950's and 1960's, Europeans were concerned that Europe would become a colony of huge American multinational companies.

In fact, some Americans were worried that we were investing too much in other countries and that U.S. companies were exporting jobs overseas to foreign countries that had cheaper wage rates or less restrictive tax laws. At the time, critics were concerned with keeping American companies in America.

Now we have the opposite concern: keeping foreign companies out. But when was the last time you heard anyone complain about the United States importing jobs?

Before addressing the effects of foreign investment, let me urge you to keep in mind the causes of that investment. Many of the reasons America is so attractive to foreign investment are quite innocuous and represent a normal turn of events.

Prominent among these reasons is the favorable business climate which makes our country such a great haven for new investments. The other reasons are directly traceable to our Government's fiscal and trade policy over the last decade.

None of the reasons can be linked to any so-called conspiracy theories to take over America.

The first point to acknowledge is the role the Federal budget deficit plays. Borrowing to finance the deficit forces the Government to compete with private groups for funds, driving up the interest rate. And when foreign investors have a chance to earn a higher interest rate in the United States than they can in their own country, their decision is obvious.

Another Government policy which has led, in part, to an increase in foreign investment is protectionist trade policy. When the United States restricts the amount foreign companies can export to our country, it creates an enormous incentive for those manufacturers to open plants in the United States, thereby circumventing U.S.-protectionist policies.

Since they cannot export all the automobiles they would like to, the Japanese, for example, open Honda factories in Ohio and Toyota plants in Kentucky. Had the Government not restricted exports in the first place, they might have had less reason to invest in factories in America.

Moreover, many foreign firms simply lack the kinds of opportunities at home that are available in the United States. When it comes to investment, the United States is currently the biggest game in town, and other countries realize it.

Since foreign investment is at least partly a result of our stable economic environment, we should welcome the fact that foreigners have such a high opinion of our economy.

Countries that try to economically separate themselves from the rest of the world face enormous problems. To reduce American companies' access to foreign capital would be to copy the failed policies of third world countries that restrict foreign investment and go against the worldwide trend toward integration.

When many goods are made of components from all over the world, we should think twice before interfering with this complex global assembly line.

Critics who suggest interfering with foreign investment are too easily clouded by flashy anecdotes about foreigners buying real estate in Los Angeles and office buildings in New York City. Such anecdotes divert attention from the true facts about foreign investment.

Foreign investors currently employ 3 million Americans and pay $80 billion a year in wages. Foreign investment creates jobs, raises wages, introduces new technology, and lowers prices for consumers.

Critics have also noted the potential loss of economic policy flexibility as a consequence of foreign investment. To the degree that we consider the reaction of foreign investors when making economic policies, we do lose some flexibility. But, if the United States loses some economic flexibility in return for increased growth, this is not necessarily a bad deal.

Let's remember that the only way to insulate economic policy from the views of foreign investors is to isolate itself from the world. That is the Albanian model. I don't think we should emulate it.

Another concern is that foreign companies have undue influence in Washington. Through hiring influential activists, they can supposedly sneak their agenda through Congress.

In other words, some are worried that the Japanese—and make no mistake about it, much of the concern is addressed toward the Japanese—can hire the same type of lobbyists that American business and labor have been using for years.

Well, the Japanese had better start spending more money—they sure haven't been very successful in stopping the United States from hitting them with trade sanctions. Besides, the policy positions foreign companies take often turn out to coincide with consumers' best interests—high-quality, low-cost products.

Protectionists have long influenced policy. Even tax policy is used as an instrument to promote American interests—usually the interests of politically powerful groups at the expense of individual consumers. Most recently, the last budget bill contained provisions, that were eventually dropped, which would have successfully discouraged foreign investment in the United States.

At the same time, our tax policies should not be used to impede the overseas investment of U.S. multinationals. It is ironic that while people complain about net foreign investment inflows, they ignore tax policy that puts U.S. companies that invest overseas at a competitive disadvantage.

Countries such as Japan and West Germany have less restrictive tax policies toward firms that invest in other countries. As a result, American companies have a harder time competing against foreign firms.

Foreign investors helped the United States grow from an undeveloped nation to a major economic power in the 1800's, and other countries have continued to look to America as the best place to invest their money. Before we panic and put American jobs at risk, we should address the underlying problems with America's economy, in particular the budget deficit. Restricting foreign investors who attempt to take advantage of America's high interest rates would be treating the symptom of a disease, leaving its causes untouched.

[The statement of Ms. Oliver follows:]

"FOREIGN INVESTMENT AND THE U.S. ECONOMY"

STATEMENT OF NANCY OLIVER
DIRECTOR OF TRADE POLICY

CITIZENS FOR A SOUND ECONOMY

BEFORE THE WAYS AND MEANS COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES

JANUARY 25, 1990

Thank you. My name is Nancy Oliver, and I am director of trade policy at Citizens for a Sound Economy -- a nonpartisan public interest group dedicated to solving pressing national problems in ways that promote economic growth and opportunity. I am glad to have the opportunity to appear before you today because CSE's 250,000 members share with all Americans a vital interest in the country's economic future. I am here today because CSE is committed to promoting the free flow of capital.

REASONS FOR THE INCREASE IN FOREIGN INVESTMENT

Before addressing the effects of foreign investment on the United States, let me urge you to keep in mind the causes of that investment. Many of the reasons America is so attractive to foreign investment are quite innocuous and represent a normal turn of events. Prominent among these reasons is the favorable business climate which makes our country such a great haven for new investments, innovations, and advancements to flourish. The other reasons are directly traceable to our government's fiscal and trade policy over the last decade. None of the reasons can be linked to any so-called "conspiracy" theories to take over America.

Foreign investment is not a new concern; it has been an issue for a number of years. In the 1950s and 1960s, Europeans were seriously concerned about American investment in their countries. Their fear was that Europe would become a colony of huge American multinational companies! Needless to say, this fear was unwarranted. American firms provided jobs without depriving any country of its national sovereignty.

In fact, there was a time when some Americans worried that we were investing too much in other countries and that U.S. companies were "exporting jobs" overseas to foreign countries that had cheaper wage rates or less restrictive tax laws. At the time, critics were concerned with keeping American companies in America. Now we have the opposite concern: keeping foreign companies out. But when was the last time you heard anyone complain about the United States "importing jobs?"

Fears similar to those now heard about foreigners "buying up America" are also not new; in the 1970s, many were afraid of the effects of Arab investment. These concerns particularly resemble the "Japan bashing" often heard today. In hindsight, from the perspective of 1990, we can see how unfounded those fears were.

In examining foreign investment in the United States, the first point that we must acknowledge is the role the federal budget deficit plays. The deficit has clear, predictable economic effects, which have indirectly led to much of the concern over foreign investment in the United States.

The government has two options when it spends more money than it takes in. First, it can print more money to pay its bills. We have all had to live with the inflationary effects of such a policy in the past. Second, it can finance the deficit the same way businesses and individuals do -- borrow the money. In fact, this is the method the government turned to in the 1980s, when the Federal Reserve controlled money growth in an attempt to wring inflation from our economy.

Unfortunately, borrowing money also has serious side effects. Borrowing to finance the deficit forces the government to compete with private individuals and organizations for funds. Since the amount of money available to be loaned is not endless, the government's competition for funds drives up their price, and the price of money, as anyone who has financed a home or automobile knows, is the interest rate. These increased interest rates have a number of effects, but today we are concerned with only one: the effect of higher interest rates on the amount of foreign investment in our country.

The basic issue is really quite simple. Foreign investors react to higher interest rates no differently than American investors. They want a piece of the action! Few Americans would turn down the chance to earn higher returns on their investment, whether an individual dealing with his retirement savings, or a multinational corporation wanting to enhance its bottom line. Now, if a foreign investor has a chance to earn a higher interest rate in the United States than he can in his own country, what do you suppose he is going to do? I think you know the answer.

In short, our concern should not be about foreign investment in the United States; it should be about dealing with policies that cause that investment, such as the budget deficit. Restricting foreign investors who attempt to take advantage of America's high interest rates would just be treating the symptom of a disease, leaving its cause -- the budget deficit -- untouched.

While the federal budget deficit partially explains why foreigners have recently invested in America, other factors also contribute to the increase. While there is controversy over the issue, a case can be made that part of the problem lies in the fact that Americans do not save enough to keep up with the pace of federal spending. If savings increased, interest rates would fall, reducing the incentive to invest in the United States. Therefore, if policymakers must concern themselves about reducing foreign investment, they should pursue policies which would increase savings.

Another government policy which has led, in part, to an increase in foreign investment is protectionist trade policy. When the United States restricts the amount of goods foreign companies can export to our country, or when it charges them high tariffs for the "privilege" of selling products to American consumers, it creates an enormous incentive for those manufacturers to open plants in the United States, thereby circumventing U.S. protectionist policies.

Automobile manufacturers are the most obvious example of this trend. Faced with quotas on the number of cars they can send to the United States, foreign manufacturers began to open plants here to build their automobiles. Since they cannot export all the automobiles they would like to, they build Mitsubishis in Illinois, open Honda factories in Ohio, and establish Toyota plants in Kentucky. This allows them to increase their access to the American market. Had the government not restricted Japanese exports in the first place, the Japanese might have had less reason to build factories in America.

Other important trends that have led to an increase in foreign investment involve the overall integration of the world economy. Many foreign firms simply lack the kinds of opportunities at home that are available in the United States. If they perceive a brighter future in America than in their own countries, it is only natural that they will attempt to invest in the United States. Since foreign investment is a result of our stable economic environment, we should welcome the foreign involvement.

It would be easy to destroy foreign confidence in the economy -- engineering a depression, for instance, would be a sure way to reduce foreign investment -- but clearly, this is not what we want to do. We should concentrate on keeping our economic prospects bright, rather than be distracted by side-effects of economic stability.

When it comes to investment, the United States is currently the biggest game in town, and other countries realize it. What other country can match our combination of diversity, size, and wealth? Due to these natural advantages, we have much to gain from the breakdown of old barriers to international trade. As overseas companies struggle to gain access to our huge domestic market, one of the main beneficiaries will be the American consumer.

WHY THE U.S. SHOULD NOT PURSUE POLICIES THAT RESTRICT FOREIGN INVESTMENT

Countries that try to economically separate themselves from the rest of the world face enormous problems, as anyone in Albania would probably tell you. While few would propose that the United States isolate itself to that degree, some still want to restrict American companies' access to foreign capital, whether through direct regulations or indirect policies such as manipulating the tax code. To do so would be to resist the worldwide trend toward integration, like that which is occurring in Western Europe.

While other countries are moving to emulate the experience of the United States and become more open, some people in the United States are still pushing for a more isolated economy. Turning back economic policy to the 18th century at the very time other countries are learning from our successes could be a tragic mistake. Texas Instruments brings computer chips to America that it has produced in Japan, and many goods are made of components from all over the world; thus, we should think twice before interfering with this complex global assembly line. Besides, as long as American consumers want to buy goods from companies headquartered overseas, those goods might as well be made in the United States as somewhere else.

One concern raised about foreign investment is the loss of economic policy flexibility. To the degree that we consider the reaction of foreign investors when making economic policies, we do lose some flexibility. But if the United States loses some economic flexibility in return for increased growth, this is not necessarily a bad deal. We can count on foreign investors to pull out of the United States if the government enacts policies that attempt to discourage investment or dismantle the global assembly line. However, such policies harm American consumers and workers as well as foreign firms. To the extent that foreign investment discourages the government from adopting economically disastrous policies, it helps safeguard the prosperity of all Americans.

Another concern is that foreign companies have undue influence in Washington. Through hiring influential activists, they can supposedly sneak their agenda through Congress. In other words, some are worried that the Japanese -- and make no mistake about it, much of the concern is addressed toward the Japanese -- can hire the same type of lobbyists that American business and labor have been using for years. Well, the Japanese had better start spending more money -- they sure haven't been very successful in stopping the United States from hitting them with trade sanctions. Besides, the policy positions foreign companies take often turn out to coincide with consumers' best interests -- high-quality, low-cost products.

Still another concern is that Americans may not be able to match the offers foreign investors make for American assets. The fear is that overseas investors may be sitting on so much cash that they can simply "buy up" America. This fear is overstated. Allowing foreign investors to bid on assets makes the American sellers better off and raises the market value of other American assets as well. Have you ever worried about paying more for a new car than you needed to? Maybe you didn't know much about the car, while the salesmen knew it inside-out. It's not a good feeling, is it? If a foreign investor is willing to come to the United States and bid so much for an asset that no American investor is willing to match it, should we really worry?

In addition, proposals to restrict foreign investment in effect tell the American people to whom they can sell their businesses -- or their homes, or their land, or their stocks. Those who would restrict foreign investment in the name of patriotism have yet to justify such a draconian departure from the principles upon which our country was founded.

Actually, flashy anecdotes about foreigners buying real estate in Los Angeles and office buildings in New York City divert attention from the true facts about foreign investment. Foreigners hold about 1 percent of farm land, 6 percent of U.S. stocks, 13 percent of corporate bonds, and 15 percent of government debt. The Japanese mainly build factories or buy bonds; real estate accounts for just 5.5 percent of Japanese investment. These numbers appear even smaller compared to the amount of foreign investment in other countries. Half of Canadian manufacturing is foreign owned. One-fifth of West German manufacturing is foreign owned. Have you heard them complain lately? Yet the U.S. trembles when 5 percent of our manufacturing is foreign owned.

Since we have, indeed, seen an increase in foreign investment in the United States, we can sit back and enjoy some important benefits. It adds savings to the economy, helping to lower interest rates, which benefits everyone from a business trying to finance a new venture to a family trying to finance their purchase of their first home. In industries where foreign firms are ahead of American firms, it brings foreign expertise and technology to America, which adds to the productivity of the workforce. Increased productivity means increased wages. A 1985 Treasury Department study found that between 1979 and 1985, U.S. affiliates of foreign companies raised their wages by 279 percent. That compares rather favorably with the 39 percent rise in overall U.S. wages. U.S. affiliates of foreign firms also increase our access to their markets.

Foreign investment is especially beneficial when America is the best place to produce a good. It allows foreign firms the possibility of more efficient production, and it creates new sources of industrial competition, lowering prices for consumers.

State governments recognize these benefits of foreign investment; in fact, they compete with each other to attract such investors. We have governors flying around the world hoping to attract foreign investment to their states in order to create new jobs and give domestic businesses access to new technology. Their enthusiasm may sometimes lead them to extremes, but no one doubts that these governors understand the benefits of foreign investment.

U.S. TAX POLICY ON FOREIGN INVESTMENT

Centuries ago, governments used to restrict trade by using their armies and navies. In more modern times, tariffs and quotas have been a popular method. Now tax policy is used as an instrument to "promote American interests" -- usually the interests of politically powerful groups at the expense of individual consumers.

We should be especially wary of international tax policies which are simply a backdoor for protectionism. The last budget bill, for instance, contained just such a measure, although it was eventually dropped. Specifically, it would have imposed a capital-gains tax on foreign investors who own 10 percent or more of the stock in a U.S. corporation. The motive behind such a proposal probably went beyond raising revenue; the Congressional Budget Office estimated that the provision would have raised only $5 million. Yet it would have successfully discouraged foreign investment in the United States. The proposal also would have violated conventional international tax rules, which contend that a shareholder's home country, not the country of incorporation, should tax the gain on the sale of stock. Indeed, a capital-gains tax of this kind would have made investment in the United States less attractive, since it had no provision to prevent both countries from taxing the same capital gain.

Do you suppose for a minute that other countries would let us get away with this without retaliating? They would respond by levying similar taxes against U.S. businesses that invest abroad. A Center for Strategic and International Studies survey of American firms that invest in the third world found that these companies do indeed prefer a government policy of "refraining from legislation or other forms of government intervention that would interfere with the free-flow of private investment capital." Protectionist tax policies could only encourage these and other nations to limit investment opportunities open to American firms.

The United States should be especially careful in developing its policy toward international investment. To embrace protectionist measures would undercut our role as the world's leading advocate of open trade. Furthermore, not only is the United States the biggest market for foreign investors, but Americans have a huge amount invested in other countries. Any moves to regulate foreign investment could indirectly punish U.S. investors in other countries by leading to retaliation against our companies.

Many people denounce the lack of U.S. competitiveness as the reason for the trade deficit. However, U.S. companies have a difficult time competing in international markets if they face a higher tax burden than their competitors. Tax policy toward U.S. companies that invest overseas puts U.S. multinational corporations at a competitive disadvantage. The U.S. government taxes at a single rate the worldwide income earned by U.S. companies. As a result, American companies have a harder time competing against foreign companies in countries with a lower corporate tax burden.

In addition, foreign tax credits were designed to reduce double taxation. However, the complexity of the system places a huge compliance burden on U.S. companies and inhibits their overseas investments. In fact, the 1986 tax reform made the laws even more complex. Some executives of multinational corporations have stated that the 1986 Tax Reform Act did more to hinder U.S. investment overseas than measures taken by foreign countries.

Foreigners can't force Americans to buy their goods. They can't force us to work for them. When locating plants in the United States, they have to follow American anti-trust and labor laws. As for the property they own, real estate, land and factories that they buy in the United States aren't going anywhere. Yet we are faced with a negative reaction to increases in foreign investment. Before we respond with reactionary restrictions, we need to remember that this type of investment isn't new. Foreign investors helped the United States grow from an undeveloped country to a major economic power in the 1800s, and citizens of other countries have continued to look to America as the best place to invest their money.

U.S. affiliates of foreign companies provide annual wages of $80 billion to some 3 million Americans. Before we panic and put American jobs at risk, let's address the underlying problems with America's economy, such as the budget deficit. Getting our savings rate back up should also help solve much of the "problem" of foreign investment. Any other course would be like giving someone with a brain tumor an aspirin -- it might make them feel better for a while, but does nothing to cure their disease.

Chairman **Rostenkowski**. Thank you.

Now Mr. Nelsen.

STATEMENT OF PETER T. NELSEN, PH.D., DIRECTOR, INTERNATIONAL TRADE COUNCIL, ACCOMPANIED BY GAIL W. PFISTER, DIRECTOR, INTERNATIONAL DEVELOPMENT INSTITUTE

Mr. **Nelsen**. Mr. Chairman, members of the committee, I am Peter Nelsen, director of of the International Trade Council.

Along with me is Gail W. Pfister, director, International Development Institute.

We appreciate the opportunity to appear before you today. We will concentrate our remarks on the investment issue.

In the free market economy, capital flows follows opportunity for earnings and expanding markets. We and the rest of the free world are only free as citizens if countries allow the freedom to invest where we wish based on earnings and personal preference.

There is concern about foreign investment in the U.S. farmland, U.S. industries and the U.S. real estate, however, these and most types of investment can only benefit the U.S. economy. They make up for the U.S.-citizens nominal savings rate and free up U.S. capital that can be invested in capital equipment and R&D.

When foreigners invest in the United States, their investment generally employs people, and pays local and Federal taxes, just as when Americans invest overseas.

In the expanding world economy, there is a pool of hard currency capital which follows opportunity, capital will move between free market countries that provide a free market environment, the right to repatriate earnings, the right to control investment, and the right to trade without direct or indirect trade barriers. These factors will determine where that investment goes.

In the growing world economy, by the year 2000, it may be about as significant whether the products or services originate in country X for country Y or vice versa as whether the chair that I am sitting on is made in North Carolina or in Ohio. We have Members of Congress who are very concerned about employment and productivity levels within their district, but the U.S. economy functions well in spite of an imperfect balance of trade within the 50 States. The free world economy can function that way as well if countries refrain from imposing legislative or regulatory roadblocks at their borders.

The United States will have a trade deficit for the foreseeable future. I wrote a paper recently which is being published next month on why we can't import less, and why we can't export more. We import oil and raw materials, we import industrial machinery, we import parts of U.S. products that may be reexported, and we import discretionary goods. Many of these are essential. The discretionary goods have a steep demand curve—people will probably buy them even if we put a high price on them.

Some of those inputs may be changed by policy. We could switch from an oil, gas, to other types of energy, and there are various policy incentives that increase productivity in order to be more competitive in the world market, thereby increasing exports.

On the export side, we are now at 5.3 percent unemployment; the Treasury Department estimates that each billion dollars worth of export demands about 25,000 workers. If we were to balance our foreign trade, we would need 5 million more workers. That would bring us down to near zero unemployment, which would be extremely inflationary. To correct that, it is again a matter of policy. We can open immigration and allow foreign workers to come in; we can manufacture overseas for overseas markets, and bring some of the profits home and thereby balance the trade, and finally we can create tax incentives to drastically improve productivity. At the present, our productivity is only increasing at about 1 percent per year. Unless these initiatives policies are addressed, we will continue to have a long-term imbalance of trade.

The dollars that go out for imported products are either going to be invested—hopefully here rather than in some competing country—or are going to be used to buy goods and services, U.S. exports, so it is not all bad.

The United States had a positive trade balance since World War II until a few years ago, and whatever other countries might be on the verge of bankruptcy, it is not because we exported that much around the world.

Our conclusion is, let's not be too concerned about the foreign investment, foreign investment is very healthy. If we didn't have foreign investment, we would be in real trouble. Let us try to address the problems that impede U.S. exports, such as many tax policies and trade barriers that put the U.S. exporters at a decided disadvantage with its overseas competitors. We can minimize the trade imbalance, but we are not likely to get rid of it in the next 20 years.

I thank you, Mr. Chairman.

Mr. GIBBONS. Thank you, sir. Very interesting statement.

[The prepared statement and a supplemental statement subsequently received follow:]

INTERNATIONAL TRADE COUNCIL
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Statement of Dr. Peter Nelsen, President
International Trade Council &
Gail Williams Pfister, Director
International Development Institute
before
The U.S. House of Representatives
The Committee on Ways and Means
January 24, 1990

Mr. Chairman and Members of the Committee, we thank you for this opportunity to submit testimony before the Subcommittee on Trade.

I am Dr. Peter Nelsen, an economist and President of the International Trade Council (ITC). My colleague is Gail Pfister, a professor of economics and the Director of the International Development Institute, which is sponsored by ITC. ITC is a trade association dedicated to the expansion of free trade worldwide. The companies we represent are largely U.S. based.

We wish to address the U.S. balance of payments, and specifically the causes and implications of the increased inflow of foreign investment in the United States. We submit that increased protectionism, or policies designed to limit foreign expenditures in the United States are not necessary and would cost the United States more in real terms than we can possibly gain. While our top U.S. trade negotiator, Carla Hills, skillfully seeks to lower the trade barriers - the rules, regulations, and subsidies that restrict U.S. trade interests now, or in the future with an integrated european market and the expansion of Japanese interests. We cannot afford xenophobia. No country today can afford to be xenophobic in the emerging world economy.

The U.S. current account deficit of $135 billion in 1988 is 2.75 percent of the G.N.P. This compares with an average of 0.2 percent of the G.N.P. from 1948 through 1980. The nominal merchandise trade deficit alone in 1988 was 2.5 percent of the G.N.P.. We cannot forsee an improvement in the trade deficit in the near, or not so near future.

It is important we note at the onset that a trade deficit entails the inflow of foreign capital. So one of the causes of increased foreign investment in this country is in the nature of accounting. Thus we might address the problem of a trade deficit running at an annual rate of $111 billion in 1989 and the appetite for imports and slowdown in U.S. export sales abroad, basically flat since last June, at another time.

Here we focus on foreign investment, and why foreigners invest. Clearly, the increase in federal borrowing swamps any potential increase in private domestic saving and much of the difference is being met by borrowing from abroad. In the decade of the 1970's our net private saving was 8.2 percent of G.N.P. The Federal Government Surplus was -0.5 percent, Net Foreign Investment was 0.6 percent and Private Domestic Investment was 7.1 percent. Compare that to 1987: net private saving was halved - that is 4.1 percent of G.N.P.; the Federal Government Surplus was -3.5 percent, Net Foreign Investment was 3.5 percent, and Private Domestic Investment was 5.1 percent.[1] The United States in opting for public spending opts for foreign capital to fund it. The rates of return and relatively risk free environment have made it attractive for foreigners to invest.

It is legitimate for Americans to question foreign investment in U.S. government securities, because that national debt is not a national credit. The United States no longer owes the money to itself. The solution to this problem is not in restricting foreign investment, it is in balancing the federal budget.

Foreigners have also invested in this country since 1985 due to the depreciation of the U.S. dollar, and U.S. monetary policy. The current account deficit persists in the face of the dollars steep decline since early 1985. This depreciation has been continuous. One would hope that it would turn the merchandise trade deficit around. But although import prices are up, it takes time for the quantity of imports to fall and exports to rise. Foreign investors have the devalued dollars to invest. But that is not an answer to why foreigners seek long term investments in the United States.

What are further reasons why foreigners invest in the United States? The U.S. appetite for foreign-made goods greater than foreign demand for our goods gives them dollars to invest, and a fiscal deficit coupled with a restrictive fiscal policy of major trading partners explain alot, but not all. Our major trading partners save more than we do, look to invest more than we do. Japan invests 1/4 of its G.N.P. in new capital equipment at home and that figure is rising, whereas the U.S. invests 1/10 of its G.N.P. in new capital equipment and that figure is falling. At the same time Japanese direct investment in the United States comprised 12.8 percent of U.S. foreign direct investment in 1987. It was superceded by Great Britain making up 28.5 percent and The Netherlands with 17.9 of foreign direct investment[8].

If capital costs, that is the rates on borrowing for equipment and machinery, are higher in the United States than Britain, Japan and West Germany as U.S.News & World Report estimates indicate[9] while U.S. compensation costs are lower than Germany and on a par with Japan it is fortunate that foreign investors are seeking Direct Investment in the United States spurring the growth of the U.S. economy. It is U.S. research and development, and U.S. productivity that stands to gain.

At this juncture it is important to remind ourselves that the United States was built on foreign direct investment, the forefathers sought foreign capital in the 19th century. Also the United States considered themselves world developers post World War II when 60 percent of direct investment in the free world was U.S. investment. Foreign portfolio investment was already 50 percent of U.S. portfolio investment in the 1970's which at that time went largely unperceived by U.S. policymakers or the American public.

Foreigners invest in U.S. factories, real estate, banks, stocks and bonds because they have the savings, or export earnings, and they see a desirable rate of return or they would not invest. It could be that outsiders perceive the future of investing in the United States, the strength of U.S. economy, and U.S. markets with a less jaundiced eye than the United States investor does. However, foreign based companies now only account for 10 percent of corporate assets in the United States. This compares with 15-30 percent in the industrial bases of France, West Germany and Great Britain. As the markets of Eastern Europe expand, and Eastern Europe becomes a further access to an integrated Western European economy, U.S. based corporations must look to invest directly, to joint ventures, to licensing, to access these markets. If G.E. and G.M. do not, if the U.S. were not to back multilateral high-tech exports, if private investors and government policy makers do not move forward, one can be sure SONY and Mercedes will. West Germany and Japan have the capital and the motivation.

Another very important consideration is that the balance of payments is actually an outdated form of accounting in this day and age. It does not show the environment. Europe is becoming an integrated economy, and global corporations that are home-based in name but like IBM or Ford, Unilever or Shell, Siemans or

Phillips rely on profits earned abroad and reinvested abroad⁴. It is necessary for the United States to succeed in liberalizing trade rules or face growing trading blocs, and bilateral agreements if the Uraguay Round fails to expand the rules of the General Agreement on Tariffs & Trade (GATT). Otherwise the United States may well resort to the dangerous parlor game of protectionism based on the natty appearance of the balance of payments, but in so doing it will fail miserably in the real world of an increasingly interdependent global economy.

United States direct investment abroad in the 1960's and 1970's aroused deep concern that the United States was exporting jobs, transfering technology, having a "negative" effect on the balance of payments, substituting for domestic investment and avoiding U.S. taxation. Now the arguments are reversed, and foreign investment in this country is blamed for exploiting labor, taking advantage of U.S. technology, substituting for domestic (U.S.) investment, and repatriating profits abroad. These are spurious arguments. Transnational or multinational corporations or small business enterprises need markets to sell goods and services. In so doing they grow. As they grow, technology transfer knows no borders, unless governments impose restrictions. Profit is reinvested where it is profitable unless governments impose restrictions or unequal tax burdens or subsidies. U.S. corporations cannot expect to regain a monopoly on competitiveness. But they can invest more, seek to sell more, and learn more from foreign investors and successful foreign management techniques.

The United States now faces prospect of expanding markets in the Soviet Union and Eastern Europe. It faces stiff competition from countries with more favorable investment incentives. In terms of foreign direct investment and portfolio investment in this country, we should be more concerned about losing it at this time than we are any so called negative effects of foreign investment. Investors follow low cost capital, locate where there are markets, and create markets.

We conclude that a beneficial switch in world expenditures toward U.S. products necessarily involves encouraging foreign investment in this country. It involves the United States seeking investment opportunities abroad as well. The whole historical experience leads to the conclusion that the U.S. economy relies on free trade. Free trade entails free choice of investment opportunities. Our need will be to encourage capital flows, not to limit them.

1.Data are averages of annual flows, as percentages of gross national product. Total net saving and total net investment deffer by statistical discrepancy. Source: U.S. Department of Commerce.

2.compiled from data supplied by the Department of Commerce

3.from basic data, Federal Reserve Bank of New York. U.S.News & World Report, Dec 25, 1989. p.41.

4.It is ironic to note that 15 years ago I wrote a book on multinational corporations, when labor was concerned that U.S. based multinationals were exporting jobs, and U.S. direct investment abroad was considered as potentially beneficial to the host country, but damaging to the U.S. balance of payments. Now we are on the other side of the fence. See Multinational Corporations, Problems & Prospects, by N.S. Fatemi and G.W.Williams (Pfister), A.S. Barnes, 1975.

Statement of Dr. Peter Nelsen, President
International Development Institute &
Anthony H. Greenberg, Director of
Legal Affairs,
International Development Institute
before
The U.S. House of Representatives
The Committee on Ways and Means
on the subject of
foreign investment in the
United States
April 30, 1990

Mr. Chairman and members of the Committee, we thank you for this opportunity to submit testimony before the House Committee on Ways and Means.

I am Dr. Peter Nelsen, an economist and President of the International Trade Council (ITC). My colleague is Anthony H. Greenberg, the Director of Legal Affairs of the ITC. ITC is a trade association dedicated to the expansion of free trade world-wide. The companies we represent are largely U.S. based.

We wish to address the issue of foreign investment in the United States. In specific, we shall address the utility of foreign investment for the health of our economy.

I. THE UTILITY OF ALL INVESTMENTS FOR THE U.S. ECONOMY

All investment in the U.S. economy helps the U.S. economy to become more productive and to grow. The United States, in fact, was built on foreign investment. The forefathers sought foreign capital in the nineteenth century. During the eighteenth and nineteenth centuries the United States was a capital importer. This nation grew on foreign investment and American ingenuity and resources. Investment injects capital into the economy, spurring new enterprises and consequently, creating new jobs. Continual investment, thus, lowers unemployment and strengthens the economy.

Besides low unemployment and a more competitive economy, investment provides other benefits as well. Investment reduces prices for consumers. The more investment which takes place in the American economy, the more enterprises emerge. The emergence of new enterprises engenders market competition which guarantees low prices for the consumer. Thus, investment (whether foreign or domestic) benefits the economy in many ways.

II. FEARS REGARDING FOREIGN INVESTMENT IN THE U.S.

As we have shown, all investment helps the U.S. economy. Nevertheless, despite the obvious benefits of investments in the U.S. there are those who would single out foreign investors as the source of the economic problems which face our economy today. These persons point to baseless anxieties concerning, for one, the "buying out" of the United States by the Japanese.

To counter these irrational fears, we need only highlight post-war European economic history. In the decades after the Second World War, Europeans voiced the very same concerns about American investment in their countries. Europeans feared that "overinvestment" would deprive them of their sovereignty and "Americanize" Europe. As we have seen, far from having been "bought out," the European economy is flourishing. American investment provided sustained economic growth and jobs without depriving any country of sovereignty.

Furthermore, allowing foreign investors to bid on assets makes the American sellers better off and raises the market value of other American assets as well. If a foreign investor is willing to come to the United States and bid so much for an asset that no American investor is willing to touch, should we really worry? [1] It is also important to realize that an overseas producer must have the right to use his earned money either to buy U.S. exports or to invest in the U.S. economy. Otherwise, our dollar would be of no greater value to the overseas investor than the Russian ruble. Consider also that the monies derived from the foreign investment are typically re-invested by the U.S. recipient as a U.S. investment either here or abroad.

Finally, let us remember that, as we move toward a global economy, within ten years, it will make no difference to anyone whether a product is fabricated in North Carolina, Ohio, Japan or Denmark. Even nowadays, the average consumer does not really care whether the bananas he bought at the store came from California or El Salvador. Moreover, the U.S. economy benefits both if a product is made in the United States, and even if the product is manufactured abroad and merely sold in the United States. If a product is made in the U.S., obviously the producer benefits from the sale of its product. But even if a product is made abroad and sold here, U.S. firms also benefit. When a foreign producer markets a product in the U.S., for example, he relies on American advertising agencies, American dealership companies, and American sales and marketing personnel. In fact, anywhere from twenty to fifty percent of the retail price of a product remains in the U.S. as compensation for these entities. Therefore, all these American entities and people are benefitting directly from foreign participation in the U.S. economy.

III. OTHER FEARS REGARDING FOREIGN INVESTMENT

As we have shown, fears of being bought out are indeed groundless. Besides the fear of being "bought out," however, some have also voiced fears that foreign companies will have undue influence in Washington. Because of their great wealth, foreign companies, it is feared, will be able to hire lobbyists to sneak their agenda through Congress. This fear has also proved baseless. In spite of the enormous wealth which Japanese industry has managed to accrue, they have still been entirely unable to stop the U.S. from hitting them with trade sanctions.[2]

Finally, fears of foreign investment in the U.S. have also been grossly exaggerated in terms of the actual percentages of foreign investments. Foreigners hold about one percent of farm land, six percent of U.S. stocks, thirteen percent of corporate bonds, and fifteen percent of government debt. Real estate accounts for just 5.5 percent of Japanese investment. These figures represent a stark contrast to foreign ownership of Canadian manufacturing, for example, which amounts to about fifty percent, or foreign ownership of West German manufacturing which amounts to twenty percent. Yet, both the Canadian and German economies prosper.[3]

Also, just as foreigners invest in the United States, U.S. dollars are also flowing overseas. American companies are spending more and more overseas on plants and equipment. In fact, General Motors' Opel unit is planning to expend more than half a billion dollars on a car-building joint venture with East Germany. IBM and Digital made most of their money in Europe last year. The Commerce Department estimates that U.S. plant and equipment spending overseas would rise thirteen percent this year to 54.9 billion dollars. So, capital investment in foreign enterprises works both ways.[4]

IV. CONCLUSION

To conclude, rather than quail at the thought of foreign investment, let us enjoy some of its important benefits. It adds savings to the economy; it helps lower interest rates, which benefits everyone from a business trying to finance a new venture to a family trying to purchase their first home; it brings foreign expertise and technology to America, which increases the productivity of the U.S. workforce. Increased productivity means increased wages.[5] as well as a competitive posture for the U.S. economy in the world.

NOTES

1. Oliver, Nancy, Foreign Investment and the U.S. Economy, Statement Before the House Ways and Means Committee (January 25, 1990), p.9

2. Ibid., p.8

3. Ibid., pp. 9-10

4. Wysocki Jr., Bernard, "U.S. Firms Increase Overseas Investments," The Wall Street Journal, (April 9, 1990) p. 1

5. Oliver, op. cit., p. 10

Mr. GIBBONS. Do you want to add to that, Ms. Pfister?

Ms. PFISTER. No; I will defer to questions. Thank you very much.

Mr. GIBBONS. Our next witness is Mr. Good.

STATEMENT OF ALEXANDER H. GOOD, ON BEHALF OF THE U.S. NATIONAL COMMITTEE FOR PACIFIC ECONOMIC COOPERATION (FORMER DIRECTOR GENERAL, U.S. FOREIGN AND COMMERCIAL SERVICE, U.S. DEPARTMENT OF COMMERCE)

Mr. GOOD. Thank you, Mr. Chairman.

It is a privilege for me to be here today and represent the U.S. National Committee for Pacific Economic Cooperation.

Mr. GIBBONS. Mr. Good, that Japanese microphone won't pick you up unless you crawl in it.

Mr. GOOD. Is that better?

Mr. GIBBONS. Yes, sir.

Mr. GOOD. Mr. Chairman, thank you for the opportunity to be here and represent the U.S. National Committee for Pacific Economic Cooperation, of which I am as a member. The U.S. National Committee is one of 15 national committees that comprise the Pacific Economic Cooperation Conference.

The conference is a bipartisan, tripartite—and by that I mean it is business, Government leaders, and academic researchers and economists that serve in their individual capacities. The purpose of the PECC is to join together to anticipate economic developments in the region and make specific recommendations on some of the key issues.

The PECC formed a task force on foreign direct investment and conducted a study in 1985 which culminated in a conference in Bangkok in 1986. The Bangkok conference looked at the regulation of foreign direct investments, primarily in developing countries, but also concerned developed countries, and came up with a broad set of guidelines that we thought could encourage freer flows of investment through appropriate rights of establishment, national treatment, and other related policies such as treatment of intellectual property.

We have continued this effort with respect to foreign investment in the United States and have issued a report which is in the written testimony. I won't go into a great deal of detail, but I would like to just touch upon a couple of salient points.

Like some of the other witnesses, we have noted the very strong benefits that come from free flows of investment: it provides jobs, technology transfer, and management transfer. Additionally, in the area of technology and skills, as the gap between United States and foreign technology capabilities narrows, the benefit to be gained by foreign investment in the United States increases. That is, as we have less to offer the rest of the world as an outward investor, we have more to gain as a host for inward investment.

Additionally, frequent investment provides capital for plant modernization and it provides competitive benefits for consumers. I could go on, Mr. Chairman, but I think a number of the witnesses have already dealt with these kinds of benefits.

We also recognize the possible pitfalls or possible downsides, including loss of exports; loss of sensitive technology, which was dealt with in the Exon-Florio amendments; skimming of research and development; and other possible detriments that are listed in our report.

As a summary, our report looked at a number of conclusions that we reached and recommendations in response to those conclusions. Let me just reiterate once again what a number of people have suggested: The size of our Federal budget deficit and our trade deficit are the driving forces behind some of the difficulties we currently face with foreign direct investment.

And as a result, the U.S. committee has strongly recommended that Congress and the administration must demonstrate convincingly that the Federal budget deficit is under control and can be reduced.

This probably is not news, but it is absolutely critical.

Mr. GIBBONS. Of course, that is without taxes.

Mr. GOOD. Yes, sir.

Second, the United States urgently requires tax and other policies which will enlarge domestic savings to finance needed investment and to increase competitiveness. We would recommend the launching of a multistep program to stimulate near-term savings, gradually shift public policy from favoring consumption and protection, and establish enforcement policy to ensure that the resultant savings will flow into investments.

We further concluded that U.S. competitiveness and leadership fundamentally will come only through superior performance, both at home and in foreign markets and not by blocking new competition that arises from foreign investment. U.S. policymakers must continue to stress more concessions from other nations in terms of opening markets and liberalizing their trade policies to U.S. producers, sellers, and investors. The real challenge for American business, however, is to reaffirm excellence by performance and not protectionism.

Mr. Chairman, those are a few of the conclusions and recommendations which are contained in our written testimony. I might add that because of the focus of our committee, we look also at direct investment within the Pacific region, and we note some statistics there that are both encouraging and discouraging.

I don't think it will come as a surprise that the level of Japanese investment, for example, in Southeast Asia, has helped boost the growth rate in a country like Thailand to in excess of 10 percent. We note that Taiwan is now the largest foreign direct investor in the Philippines. As a result of the new embankment, if you will, from the newly industrialized countries in the Pacific, there have been liberalizing trends to foreign investment throughout much of Southeast Asia and much of the other parts of the developing countries in the Pacific.

We think this is a very positive trend. Any action taken by the United States that could be viewed as limiting or discouraging the free flow of investment we think would be counterproductive to that positive trend.

We have got a ways to go, but we are delighted with the trend. I might make one final comment. There has been discussion in this hearing about competition for the investment dollar from other sources, particularly in Western Europe. We might add that as the infrastructure in Asia continues to grow, and as those economies move to liberalize their regulations, they present a major competitive challenge for the investment dollar that could flow into the United States and the benefits that would be derived therefrom.

Mr. Chairman, I appreciate the opportunity to appear before this committee. Thank you.

[The statement of Mr. Good follows:]

STATEMENT OF ALEXANDER H. GOOD ON BEHALF OF THE U.S. NATIONAL COMMITTEE FOR PACIFIC ECONOMIC COOPERATION

Mr. Chairman, I am speaking today in my capacity as a member of the U.S. National Committee for Pacific Economic Cooperation, a non-partisan organization that was formed in 1984 to serve as the U.S. member of the Pacific Economic Cooperation Conference, (PECC). The PECC comprises national committees similar to ours in more than a dozen other Pacific Basin economies and is headquartered in Singapore. Although PECC is a private sector organization, senior governmental officials serving in their individual capacities participate alongside business representatives and leading academics and researchers. Attached to this testimony is a list of the full membership of the U.S. Committee. The purpose of the organization is to anticipate economic developments in the region and explore new opportunities for regional cooperation. Its "unofficial" status has enabled it to include in its policy dialogues representatives of economies that do not have diplomatic relations. As a result, throughout the past decade both the membership and scope of the organization have grown rapidly. The PECC looks forward in the coming months and years to establishing a collaborative relationship with the new forum of Pacific Basin foreign and economic ministers known as APEC (Asia-Pacific Economic Cooperation).

During the past three years, the U.S. National Committee has taken a leadership role within the PECC on the subject of foreign direct investment. Through an initiative which culminated at a major regional meeting in Bangkok in 1986, the PECC formulated guidelines by which governments in the region could encourage new foreign investment flows. While this initiative focused on the investment flows into developing countries, it also concerned industrial country investment policies. Foremost among these recommendations was that of reducing the complexity of the many regulations and incentives that governments create for the purpose of both encouraging and controlling direct foreign investment.

Consistent with that international leadership role, the U.S. National Committee of PECC also formed a special subcommittee on direct foreign investment chaired by Walter Hoadley, formerly the Executive Vice President of the Bank of America, now a Senior Research Fellow at the Hoover Institution. The purpose of the subcommittee is to assess the pros and cons of direct foreign investment in the U.S. As a member of the subcommittee, I am especially gratified at your initiative, Mr. Chairman, in convening a hearing on this subject. Direct foreign investment into this country, particularly in view of the large increases in investment originating from single countries such as Japan, is a matter of mounting concern to American citizens.

Let me summarize in the brief time remaining the main findings of the subcommittee:

The **benefits** that accrue from direct foreign investment are that it can:

- Add jobs and capital for domestic businesses,
- Increase liquidity for U.S. owners,
- Provide input of foreign ideas, expertise, technology and management techniques into the U.S.,
- Aid U.S. consumers through added competition,
- Help internationalize U.S. businesses and organizations.

The **risks** inherent in direct foreign investment are that it can:

- Serve as a take-over tool, shifting production and reducing U.S. exports,
- Threaten national security in sensitive fields,
- Allow "skimming" of U.S. research and development efforts for later production abroad,
- Lead to "shell" companies that are used to pick off U.S. competitors,
- Overinflate prices and escalate property taxes,

Part of the difficulty Americans face in assessing these advantages and risks is the lack of information and basic background knowledge that is available. The Committee generally believes that the principle of seeking more complete and reliable data on foreign investment is a sound one providing it does not compromise proprietary company information or impose additional burdens on industry. However, care must be taken to minimize the burden of data collection, or other legislated elements which might have a "chilling effect" on prospective foreign direct investment.

I would like at this point to submit for your consideration the full set of conclusions and recommendations by our subcommittee. While these were prepared some months ago, we believe that principal conclusions remain unchanged. These have been discussed by the full U.S. Committee and approved for general distribution. We hope they will be of use to your deliberations and are prepared to work with the Committee as it continues its review of foreign investment in the United States.

Conclusions of the

U.S. National Committee for Pacific Economic Cooperation
Subcommittee on Foreign Investment Policy in the U.S.

The growing economic interdependence of the world continues to raise new challenges to U.S. policy makers and voters. At stake is the future of American competitiveness and global leadership.

For decades, this country dominated the world economy with little economic threat from others. U.S. open market policies were fairly easy to adopt and pursue. But, conditions have changes.

In recent years, the power of private sector management has been unleashed across much of the world following the U.S. example. Meanwhile, the American economy had matured and is now confronted with enormous competitive challenges from certain other economies.

The choice today is whether the U.S. will: (1) adopt a defensive protectionist posture, blame others to ease or resolve its problems, and adopt policies to "manage" trade and investment to correct international imbalances; (2) formulate a new strategic policy calling for more enlightened and concerted government-private action to meet forcefully foreign competitive tactics and strategy, or (3) reaffirm free market principles and push ahead to regain preeminence wherever reduced or lost. Public and private policy makers now seem well divided, regarding these three choices, with strong feelings on all sides.

Strikingly, the debate more and more has shifted from trade to investment. The most strident U.S. views on trade issues stress "fairness" and "level playing field". Currently, the investment focus is on foreigners "buying America on the cheap." The recent Trade Bill and anti-foreign investment public poll results reflect serious protectionist overtones. Persistent protectionism inevitably leads to serious international conflicts.

The last Congress came close to enacting some fairly restrictive legislation on investments, but settled for more disclosure, review, and a more explicit process to block selective foreign takeovers. The new Congress seems certain to continue to investigate the foreign economic invasion issue more thoroughly with threatening consequences for longstanding U.S. open market principles.

Some facts:

1. Total foreign assets in the United States exceed $1.5 trillion, a five-fold increase in the past decade: foreigners own approximately 1.5 percent of U.S. non-farm and non-residential real estate.

2. The value of foreign assets in the U.S. reportedly exceeds the value of U.S. assets overseas by roughly one-third, but accounting valuation differences limit our ability to make precise comparisons.

3. Direct investment (i.e. foreign ownership of companies and real estate) accounts for less than 20 percent of total foreign investment in the U.S.; a surplus of net direct investment still favors the U.S. vs. foreigners, but foreign investment in the U.S. is becoming more concentrated in "trophy" properties.

4. Portfolio investment (i.e. foreign ownership of stocks, bonds, deposits, and official reserves) accounts for more than 80 percent of total foreign assets in the U.S.; includes roughly 10 percent of U.S. Treasury securities, 15 percent of U.S. corporate bonds, and nearly 20 percent of U.S. banking assets.

5. The United Kingdom and Japan lead in foreign ownership in the U.S.

6. Foreign owned firms from investment and acquisition employ about 3 percent of all U.S. workers.

How much longer can foreign investment be expected to grow in the U.S.?

-- Indefinitely, as long as the U.S. trade deficit persists; Americans are paying foreigners for the net surplus goods and services we are buying versus what we are selling abroad.

--U.S. assets continue to be relatively quite attractive because of higher average profit returns and greater political stability; U.S. assets still constitute a small fraction of total overseas holdings of foreigners.

-- Investment will always flow from country to country as current account balances shift to reflect changing economic forces at work.

What are the benefits of foreign investment?

Direct Investment: adds jobs and capital for U.S. businesses; increases liquidity for U.S. owners; provides input of foreign venturesomeness, technology and management techniques into the U.S. economy; more competition aids U.S. consumers; and helps internationalize provincial U.S. business organizations, as well as helps reduce cross border imbalances.

Portfolio Investment: helps U.S. finance its budget deficit; reduces upward pressure on interest rates; gives strength to the U.S. dollar; and, improves financial stability since foreigners tend to be long term investors.

What are the risks of foreign investment?

Direct Investment: could be a tool through take-overs to shift production and reduce U.S. exports; poses a threat to U.S. national security in certain sensitive fields; places economic resources and profits in the hands of foreigners who can be expected to use them to further their own interests -- not those of the U.S.; allows "skimming" off the top of U.S. research and development (especially via American universities) for later production abroad; can lead to U.S. "shell" companies used to pick off U.S. competitors; and, can over-inflate prices and thus also escalate property taxes. Risks are aggravated by inadequate information on what actually is occurring among foreign investors which intensifies suspicions with or without justification.

Portfolio Investment: Addiction to foreign savings is risky; increases vulnerability of U.S. financial system as foreign decisions impact markets; major short-term adjustments required whenever the flow slows or stops, e.g., fall in the exchange value of the U.S. dollar and more inflation; already there is a shift in foreign investment to more direct investment and less portfolio investment to reduce currency losses from a weakened dollar; and, the natural progression from "learning" from portfolio investment to more take-overs and management of U.S. enterprises can accelerate.

What is the status of U.S. regulation of foreign investment?

Reporting - Foreigners must register with the U.S. Secretary of the Treasury and respond to annual confidential information surveys by the Bureau of Economic Analysis in the U.S. Department of Commerce.

Screening - Since 1975, a U.S. government interagency group -- the Committee on Foreign Investment in the United States (CFIUS) -- has been empowered to review foreign investment which potentially is not in the national interest; in 1988, Congress passed the Exon-Florio amendment which enlarged CFIUS and made a fundamental change in policy to give the President a high degree of discretion and statutory authority to block foreign acquisitions and mergers; "national security" is to be interpreted more broadly; and notification and investigation procedures now create a 90 day "window of vulnerability" for transactions with foreign purchasers --but many complex issues remain amidst protectionist and other political pressures; foreigners must be encouraged to "add" to the U.S. economy's productive capacity, housing, etc. -- not merely take title to existing assets.

Reciprocity - is not a part of general U.S. law covering foreign investments, except for trading in government securities. Foreign investors are accorded "national treatment," i.e., the same privileges and obligations as U.S. organizations.

Banking - The International Banking Act of 1978 was designed to insure competitive equality between U.S. and foreign banking institutions; reciprocity is not a strong factor; shortcomings have led to some international (G-10) minimum capital standards to be phased in by 1992; interstate banking is still an unresolved and controversial issue among foreign and U.S. banks.

Conclusions and Recommendations:

1. The fundamental driving force behind rising foreign investment in the United States is the U.S. federal budget deficit plus the trade deficit which promote dependence on foreign capital and provide funds for foreigners to invest in America -- all of which erodes American global leadership and credibility.

Recommendation: Congress and the Administration must demonstrate convincingly that the federal budget deficit is under control and being reduced.

2. The U.S. urgently requires tax and other policies which will enlarge domestic savings to finance needed investments to increase competitiveness.

Recommendation: Launch a multi-step program (1) to stimulate near-term savings by new tax and other incentives, (2) gradually shift public policy from favoring consumption to production, and (3) establish enforcement policy to insure that resultant added savings in fact flow into investment.

3. U.S. competitive resurgence and strong leadership fundamentally will come only through superior performance at home and in foreign markets -- not by blocking new competition from foreign investment.

Recommendation: U.S. policy makers must stress more concessions from other nations to open their markets to U.S. producers, sellers, and investors, but the real challenge for American business is to reaffirm excellence by performance not protectionism.

4. Evidence continues to mount that U.S. companies are continuing to fall behind in areas of strategic research and development, to a substantial degree because of excessive priority on short-term, quick return projects; persistent direct and indirect tapping of U.S. university related research is a contributing element.

Recommendation: Explore in far greater depth what public, private and not-for-profit policy changes are needed to stimulate more private long-term research and development; accelerate the commercialization of government financed research findings in space, defense, and related fields; and adopt goal of full tax credits for research and development over several years.

5. Information and intelligence in investment are critical elements in formulating U.S. public and private policies; such data are widely used by foreign nations and business organizations.

Recommendation: Continue U.S. data collection of foreign investment and improve the reliability and utility of such data (being careful to avoid compromising proprietary company information or imposing additional burdens on industry) particularly in sensitive or potentially sensitive industries, e.g., high tech defense, genetics, professional electronics, etc.; reappraise and improve investment surveys to increase the understanding of foreign investor motives and underlying ownership of investment.

6. The general public continues to lack even rudimentary understanding of market principles and in particular the growing international economic interdependence of the United States.

Recommendation: Urge foreign investors to demonstrate regularly that their investments to the U.S. economy are in our mutual interest; and demand that American educators include in their curriculum more instruction in economics generally and international economic relations in particular.

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Mr. **Gibbons**. Thank you, sir.

And now, Mr. Walker.

STATEMENT OF CARY C. WALKER, WASHINGTON REPRESENTATIVE, CALIFORNIA STATE WORLD TRADE COMMISSION

Mr. **Walker**. Thank you, Mr. Chairman. Good afternoon, Mr. Chairman, members of the committee. On behalf of the California State World Trade Commission, I want to thank you for the privilege and the opportunity to testify today.

The World Trade Commission is a unit of the Governor's office, and it's responsible for promoting international trade investment in California. Members include some of California's leading business executives, and they are appointed by the Governor and the legislature.

They meet several times a year and convey the interests of business, of California's business community to officials, policymakers, in Sacramento and Washington, DC.

I would like to tell you very briefly what foreign direct investment means to California and why we oppose legislation that would create additional foreign investment disclosure requirements. California leads the Nation in foreign direct investment. By the end of 1987, our State was home to more than 2,000 foreign affiliates with a gross value of exceeding $42 billion. That is 12.3 percent of the U.S. total.

Foreign interests hold some 924,000 acres of American farm land worth $2 billion and a significant interest in 160 banks with estimated assets of some $100 billion.

For decades, overseas capital has made a mighty contribution to California's economy and its emergence as a powerhouse on the Pacific Rim. British money, for example, helped finance construction of railroads which opened California to the American continent.

Canada is now the leading investor in California—that might take some people by surprise—with $6 billion worth of property, plant, and equipment. This capital accounts for some 34,000 jobs.

Canada is followed by Japan, which has invested $5.3 billion and employs nearly 60,000 people.

Next comes the United Kingdom.

It may be that the rise of foreign direct investment in the United States is tied to our current account deficit. A weak dollar, the high cost of capital, and protectionist trade policies are often held responsible for the surge in foreign capital that America has received in recent years.

Or it may be that the United States, which for so long has been the home of multinational corporations, is simply becoming more like the rest of the world and moving toward greater global economic integration.

Despite its rapid growth in the United States, for example, foreign direct investment still plays a much bigger role in nations such as Canada, France, West Germany, and the United Kingdom.

I do not know why foreign investment in the United States is skyrocketing, nor am I sure I can tell you why this is seen as a sinister development on the part of a growing number of people.

California is a naturally attractive place for people to invest their money. It's the eighth largest economy in the world, a $550 billion market of 27 million people.

International commerce, as I mentioned, is the cornerstone of California's economic development. This week, California State treasurer, Tom Hayes, is in Hong Kong to open up California's fifth overseas office. In each of these offices we seek to promote exports and attract job creating capital. The directors in Tokyo, London, Frankfurt, and Mexico City all report directly to the Governor's office.

In welcoming foreign direct investment to California, we seek to create jobs and generate revenue. Working with local regional economic development agencies, we provide assistance with site location, permitting assistance, and the like.

I should note that California's investment policy is not discriminatory. That is to say, all incentives offered by the State are available to foreign and domestic companies alike.

Not only does foreign investment introduce technologies, management techniques, and worker skills, it also boosts employment, productivity, trade and tax revenue.

Examples abound. In Roseville, a town near Sacramento, NEC Electronics' $400 million expansion of a semiconductor facility is expected to create about 400 new jobs, bolster the local economy, and contribute further to our high technology capabilities.

This marks the second time that NEC, which has launched its Roseville operation in 1984, has chosen California as the place to invest.

In Berkeley, a German consortium has joined forces with the University of California to create the International Computer Science Institute, a facility to advance high tech capability.

And in Southern California, Hitachi Chemical has reached an agreement with the University of California, Irvine, to build a $12 million research facility that will be used jointly with the university's college of medicine. The university will receive 100 percent of the patent rights.

Before Congress right now are several bills that would require disclosure of certain information about foreign investment in the United States. Among them is H.R. 5 by Congressman John Bryant, which we heard about earlier.

The World Trade Commission opposes the creation of additional foreign investment disclosure requirements. Enactment of such legislation would run counter to the interests of American business and the U.S. economy as a whole.

First, it would fail to make significant improvements in the collection and presentation of foreign investment data. Despite its shortcomings, the current information is relatively sound. Indeed, the Royal Institute of International Affairs in London published a report on foreign investment in the Group of Five nations and hailed BEA statistics as more open and detailed than those available in other countries.

Second, since virtually all of the information required by H.R. 5 is already collected, the issue turns not on data improvement, but disclosure.

Third, the bill would target foreigners. Nonlisted foreign controlled companies would have to disclose information that nonlisted domestic companies could keep confidential. Moreover, because the bill's language is vague, an investor reporting more than 25 percent of a company, or $20 million in sales, could be forced to disclose far more detailed information than is required of American investors.

Fourth, disclosure legislation signals a sharp departure from the U.S. policy of neutrality toward foreign investment. In addition to ignoring the globalization of manufacturing, services, and information technologies, such requirement would torpedo the Uruguay round of negotiations to liberalize trade and trade-related investment.

Additional requirements could also prompt foreign retaliation and make it more difficult for American firms to compete in the world economy.

Investors are wary of Government intrusion. They place money in the United States because its economy and political system are stable. Additional disclosure requirements could drive the capital from job creating plants and equipment into portfolio investments—stocks, bonds and the like that can be withdrawn in seconds.

Mr. Chairman, we hear a lot today about an increasingly competitive global economy. But this phrase is not just some cliche whipped up by the world high-powered financial consultants. It reflects the continuing growth and rationalization of multinational companies all over the world.

Investors all seek returns that are available only through comparative advantage and economics of scale. Foreign companies will invest in the United States just as our firms continue to build and expand abroad. By allowing resources to seek their most effective and productive use, the free-flow of capital improves the living standards to people everywhere.

Additional foreign investment disclosure requirements are unnecessary. The U.S. Government already collects detailed information and publishes statistics in aggregate form.

H.R. 5 would require the disclosure of information about individual enterprises because they are foreign. We must press for the removal of restrictions that block investment opportunities abroad.

The United States has placed before for the General Agreement on Tariffs and Trade a sound proposal that reaffirms important principles and takes aim at unfair performance requirements. The administration and Members of Congress should vigorously support it, and I look forward to working with you to offer our support.

Mr. GIBBONS. Thank you, Mr. Walker.

[The statement of Cary Walker follows:]

STATEMENT OF CARY WALKER
CALIFORNIA STATE WORLD TRADE COMMISSION

Good morning Mr. Chairman, members of the committee. On behalf of the California State World Trade Commission, I want to thank you for the opportunity to testify today.

The World Trade Commission, a unit of the Governor's office, is responsible for promoting international trade and investment. Members, who are appointed by the Governor and the Legislature, meet several times a year and convey the interests of our business community to policy makers in Sacramento and Washington, D.C.

I would like to tell you briefly what direct investment means to California, and why we oppose legislation that would create additional foreign investment disclosure requirements.

CALIFORNIA'S STAKE IN FOREIGN DIRECT INVESTMENT

California leads the nation in foreign direct investment. By the end of 1987, our state was home to more than 2,000 foreign affiliates with a gross book value exceeding $42 billion -- 12.3 percent of the U.S. total.

Foreign interests hold some 924,000 acres of farmland worth $2 billion, and a significant interest in 160 banks with estimated assets of more than $100 billion.

For decades, overseas capital has made a mighty contribution to California's emergence as an economic powerhouse. British money, for example, financed the construction of railroads that opened California to the American continent.

Canada is the leading investor in California with $6 billion worth of property, plant and equipment. This capital accounts for some 34,000 jobs. Following Canada is Japan, which has invested $5.3 billion and employs nearly 60,000 people. Investment by the United Kingdom is estimated to deliver some 53,000 California paychecks.

It may be that the rise of foreign direct investment in the United States is tied to our current account deficit. A weak dollar, the high cost of capital and protectionist trade policies are often held responsible for the surge of foreign capital that America has received in recent years. Or it may be that the United States, which for so long has been the home of multinational corporations, is simply becoming more like the rest of the world and moving toward global economic integration. Despite its rapid growth in the United States, foreign direct investment still plays a bigger role in the economies of Canada, France, West Germany and the United Kingdom.

I do not know why foreign investment in the United States is skyrocketing, nor am I sure that I can tell you why this is seen by a growing number of Americans as a sinister development.

California is a naturally attractive place for people to invest their money. It is a $550 billion market of 27 million people -- the eighth largest economy in the world.

It is also the birthplace of modern technology. Investors enjoy easy access to first-class educational institutions, 20 percent of the nation's industrial research laboratories and world-class ports that handle $140 billion worth of goods each year.

International commerce is the cornerstone of California's economic development. This week, California State Treasurer Tom Hayes is in Hong Kong to open our fifth overseas trade and investment office. In each one, we seek to promote exports and attract job-creating capital. The directors in Tokyo, London, Frankfurt and Mexico City report to the Governor's office, and they work closely with the World Trade Commission and the California Department of Commerce.

The Commerce Department's Office of Foreign Investment seeks to create jobs and generate revenue. Working with local and regional economic development agencies, its representatives provide site location and permitting assistance; low-interest financing for infrastructure improvements and pollution abatement; and grants and tax credits for worker training in high-unemployment areas.

I should note that California's investment policy is not discriminatory. All incentives offered by the state are available to foreign and domestic firms alike.

Not only does foreign investment introduce new technologies, management techniques and worker skills, it also boosts employment, productivity, trade and tax revenue.

Examples abound:

- In Roseville, NEC Electronics, Inc.'s $400 million expansion of a semiconductor manufacturing facility is expected to create 400 new jobs and bolster the local economy. This marks the second time that NEC Electronics, which launched its Roseville operation in 1984, has chosen California as a place to invest.
- In Berkeley, a German consortium has joined forces with the University of California to create the International Computer Science Institute, a 14,000 square-foot facility to advance high-technology capabilities.
- And in Southern California, Hitachi Chemical, Ltd. has reached an agreement with the University of California, Irvine to build a $12 million research facility that will be used jointly with the university's college of medicine. The university will receive 100 percent of patent rights, and I should note that Hitachi has made a generous contribution to the Children's Program at the Performing Arts Center in Orange County.

U.S. POLICY

For the most part, America's policy toward foreign investment is neutral. Underlying this approach are two principles. The first is "national treatment," which specifies that neither foreign nor domestic companies should encounter obstacles or receive privileges that are discriminatory. The second is the "right of establishment" -- the ability of foreign companies to launch or expand operations under the same ground rules that apply to domestic companies.

Exceptions to U.S. policy generally involve national security. Examples include nuclear energy, telecommunications, domestic shipping, aviation and all defense production needing government security clearance.

In addition, the "1988 Trade and Competitiveness Act" contains an amendment, authored by Senator James Exon (D-Nebraska) and Rep. James Florio (D-New Jersey), which allows the President to block any foreign merger, acquisition or takeover of a U.S. firm if the transaction would threaten national security. Administering this provision is the interagency Committee on Foreign Investment in the United States.

I should note that reciprocity supersedes neutrality in several sectors. Leases for certain minerals and fuels on federal lands cannot be obtained, for example, by a foreign investor whose home country denies similar access to U.S. interests.

DATA COLLECTION

Various agencies collect information pertaining to foreign investment in the United States. The "International Investment and Trade in Services Survey Act of 1976" (amended in 1982) designates the Bureau of Economic Analysis (BEA) as the primary agency responsible for collecting data on foreign direct investment.

The agency publishes an annual report on the U.S. net investment position, as well as a comprehensive, five-year Benchmark Survey of Foreign Direct Investment. Broken down by state, it includes the sales of U.S. affiliates, employment and gross book value of property, plant and equipment.

Critics say BEA's data are too imprecise for effective analysis. Aerospace, for example falls under the category of "other transportation." They argue that the agency overstates employment generated by foreign investment and understates its value by failing to routinely track expansions.

Moreover, a company's investment is classified according to its principal business. Consequently, a multinational electronics firm that makes a real estate purchase in California through one of its subsidiaries would be credited with an electronics investment.

U.S. INVESTMENT ABROAD

The book value of foreign direct investments in the United States reached an estimated $360.3 billion through the end of June 1989. This compares with an estimated $335.1 billion for U.S. direct investment abroad. Estimates by the Federal Reserve System's Board of Governors place the current market value of U.S. overseas direct investment at $750 billion, with foreign direct investment in the United States valued at $450 billion.

None of the G-7 countries (the United States, Japan, West Germany, the United Kingdom, France, Italy and Canada) has an official policy of restricting foreign investment. However, their policies and practices are not entirely consistent. Virtually all of them limit foreign investment in the air and maritime transportation industries, telephone operations, radio and television broadcasting, financial services, insurance and nuclear energy.

Some nations, including Canada and France, screen foreign acquisitions. In others, particularly Japan, foreigners find it hard to do business. Land prices and labor costs are high. U.S. officials note that the Japanese have invested some $58 billion in this country, far more than the $17 billion worth of assets which we own in Japan.

CURRENT AND PROPOSED LEGISLATION

Before Congress are several bills that would require the disclosure of certain information about foreign investment in the United States. Among them is H.R. 5, a proposal sponsored by Representative John Bryant (D-Texas). This measure calls on foreign investors holding a 5 percent or greater interest in a U.S. business, or those with real estate valued at $5 million, to reveal their identities, nationalities, addresses, industries, dates acquired, sizes of interest and the purchase price. In addition, any foreign investor with an interest of over 25 percent, or annual U.S. sales of more than $20 million would have to file its balance sheet as well as statements of income, sales, assets, operating income, location of U.S. facilities and nationalities of directors and officers.

Rep. Bryant's bill would make the data available to employees, consultants and researchers with the Commerce Department as well as members of Congress, the General Accounting Office (GAO) and a single agency in each state.

H.R. 5's companion bill -- S. 289 -- was introduced in the Senate by Tom Harkin (D-Iowa).

CALIFORNIA'S POSITION

The World Trade Commission opposes the creation of additional foreign investment disclosure requirements. Enactment of such legislation would run counter to the interests of American business and the U.S. economy as a whole.

First, it would fail to make significant improvements in the collection and presentation of foreign investment data. Despite its shortcomings, this information is relatively sound. Indeed, the Royal Institute of International Affairs in London published a report on foreign investment in the Group of Five nations and hailed BEA statistics as more open and detailed than those published by other countries.

Second, since virtually all of the information required by H.R. 5 and S. 289 is already collected, the issue turns on disclosure rather than data improvement.

Third, the bills would target foreigners. Non-listed foreign-controlled companies would have to disclose information that non-listed domestic firms could keep confidential. Moreover, because the bill's language is vague, an investor reporting more than 25 percent of a company or $20 million in sales could be forced to disclose far more detailed information than is required of American investors.

Fourth, mandatory disclosure would signal a sharp departure from the U.S. policy of neutrality toward foreign ownership. In addition to ignoring the globalization of manufacturing, services and information technologies, such requirements would torpedo Uruguay Round negotiations to liberalize trade-related investment. Mandatory disclosure could also prompt foreign retaliation and make it more difficult for American firms to compete in the world economy.

Investors are wary of government intrusion. They place money in the United States because its economy and political system are stable. Disclosure requirements could drive capital from job-creating plant and equipment projects into portfolio investments that can be withdrawn in seconds.

Foreign investment data may be improved through greater interagency coordination. We are interested in S. 856, authored by Senator Frank Murkowski (R-Alaska). This measure would codify the collection of foreign investment data and give employees of BEA access to statistics gathered by the Census Bureau. It would also allow BEA to share its information with the interagency Committee on Foreign Investment in the United States.

CONCLUSION

You and I hear a lot about "today's increasingly competitive global economy." But this phrase is not just some cliche whipped up by the world's high-powered financial consultants. It reflects the continuing growth and rationalization of multinational companies.

Investors all seek returns that are available only through comparative advantage and economies of scale. Foreign companies will invest in the United States just as California firms continue to build and expand operations abroad. By allowing resources to seek their most productive use, the free flow of capital improves the living standards of our people.

Additional foreign investment disclosure requirements are unnecessary. The U.S. government already collects detailed information and publishes statistics in aggregate form. H.R. 5 and S. 289 would require the disclosure of information about individual enterprises because they are foreign.

Mr. Chairman, the World Trade Commission believes that we must press for the removal of restrictions that block investment opportunities abroad. These barriers should be addressed within a multilateral framework. The United States has placed before the General Agreement of Tariffs and Trade a sound proposal that reaffirms important principles and takes aim at unfair performance requirements. The Administration and members of Congress should urge our trading partners to support it.

We look forward to working with you and members of the committee in strengthening the competitive position of American business.

Thank you very much.

Mr. **Gibbons**. And now, do the members have questions?

Mr. **Cardin**. Thank you, Mr. Chairman.

I would just like to make somewhat of an observation related to this panel and the last panel. It seems the conclusion here is that foreign investment has some very positive effects on our economy, which is very much needed as far as expansion is concerned and that it is very sensitive to our tax policies and to restrictions or disclosure laws that may be passed here.

And it is also very sensitive to the interest rates in the United States. Our President has indicated that he wants the interest rates to decline and that the administration's policy is going to do everything it can to reduce interest rates in this country.

Do we need to have higher interest rates or we are going to be losing short-term foreign investments in this country? It is very unlikely that there is going to be any immediate change in other domestic policies that will reduce the dependence upon the need for foreign investment.

So I guess I will welcome some observations here as to whether we are heading for a real crisis as far as the availability of foreign investment that is needed in this country. Given the dilemma between our domestic policy to reduce interest rates and perhaps if we impose other restrictions, does the foreign investor see the United States as less attractive then as he did a few days ago?

Ms. **Pfister**. Mr. Cardin, I would like to answer that.

I appreciate your observation.

Mr. **Gibbons**. Talk into the microphone, please, ma'am. I am sorry about these microphones.

Ms. **Pfister**. Is that on at all?

Mr. **Gibbons**. Yes. You have to get real close.

Ms. **Pfister**. OK.

It is certainly true that this panel has been more for proforeign investment and one thing that has not been mentioned by anyone, except Mr. Gradison this morning, was that in the future we are going to—we very well may need higher interest rates to attract foreign investment.

When we are facing Europe, an integrated Europe in 1992, when we are facing the opening of the Eastern bloc, we are also facing $5 billion of Japanese capital in one country, Hungary alone. These investments are happening daily. We are very soon going to be begging for foreign capital.

And I couldn't agree with Mr. Bergsten more. We are hooked on foreign capital. Naturally, there is a question of national security when we are talking about high-tech industries. There is a question when we are talking about Government securities of whether our national security is in danger should they wish to pull out. But these issues are to be answered as was said earlier, by a national policy of bringing our budget into balance.

And, yes, you are right. There is, as you mentioned right off the bat, there is a fiscal and a monetary policy dilemma—we are at odds. Our easy money theory, if you want, has us in a difficult position, because we do need the higher rates tighter money on the one hand in an international environment to attract foreign investments.

Mr. **Cardin**. But you think that the higher interest rates will prevail, despite the administration's efforts to reduce the interest rates for other reasons?

Ms. **Pfister**. I believe they will. Look what is happening now with the long-term rates and what is happening in Tokyo and Frankfurt.

Mr. **Cardin**. Mr. Nelsen.

Mr. **Nelsen**. Higher interest rates will encourage portfolio investment and lower interest rates will increase productivity and competitiveness necessary for the United States to export more.

We should keep both of those things in mind.

Mr. **Cardin**. You can't have both, though.

Mr. **Nelsen**. Then let the economy set the level rather the Government trying to influence it.

Mr. **Cardin**. Thank you, Mr. Chairman.

Mr. **Gibbons**. But couldn't we all agree, the problem is that we don't generate enough capital in this country; isn't that the basic problem in all of this issue?

Mr. **Nelsen**. Well, we are very lucky that the United States is a safe haven for investment and money basically is fungible and has no partisan or national bias—it just makes very little difference whether money is invested by an Irishman who has been here 10 generations or somebody is investing over here from Dublin. It creates employment; it creates investment; it creates productivity.

Mr. **Gibbons**. I agree with you. I don't advocate cutting off foreign investment, or even collecting all the indicia that one of our witnesses wanted to collect today. But won't we be better off in the long run if we could generate more capital internally, in our own market, because the dividends on that capital would come back into the American market?

Mr. **Nelsen**. Absolutely. And the only way to do that is to change the Government tax investment and trade policies.

Mr. **Gibbons**. The real problem is we just live a little higher on the hog than we can afford to live. All of us. You, me, Mr. Cardin, not Andy, not Andy. He is very thrifty.

But the Government as a whole. The damn credit cards have gotten us.

Mr. **Nelsen**. Well, the fact is that we are the largest consumer market in the world that creates some of the initiative and some of the incentive for the foreign investment here.

Mr. **Gibbons**. Oh, yes. There is no doubt about it. We have got more consumer goods. I've got a house. I've got half the Rayburn Building full, two houses down in Florida. I am waiting to double on the antique market. That is the next place for me to go.

But the real problem that we have, and what has caused all this great commotion, if it is a great commotion—and I don't think it is anything more than somebody found something they want to talk about and it sounds sophisticated to talk about it—is that we just are living high on the hog. We are not saving enough of the seed corn to go back into the industry, and we are lucky that the foreigners are bringing us their savings and letting us play with them for a year.

Mr. **Nelsen**. We are part of the world economy, and whether the capital comes from here or from Japan and Germany this year, doesn't matter. Twenty years ago the capital came from New York State.

Mr. GIBBONS. Sure.

Mr. NELSEN. To finance West Virginia, Pennsylvania, and every other State.

Mr. GIBBONS. And Florida.

Mr. NELSEN. And Florida. And in the long run, it won't make that much difference where the capital comes from. We will be part of one global economy.

Mr. GIBBONS. As long as it is used for productive purposes.

Mr. NELSEN. Yes.

Mr. GIBBONS. Won't you put that qualification on? I don't know who is going to decide productive purposes, but——

Mr. NELSEN. That is the question, is it only productive if you buy a more efficient refrigerator, or is it also productive if you go on vacation and spend your money that way.

Mr. GIBBONS. Well, suppose you invested in a sailboat and tied up down at pier 66 down in Florida, and you visited every now and then and make sure it is still there, that the drug traffickers haven't carried it off.

Mr. NELSEN. I think that is an excellent choice. I have a boat down here in Maryland.

Mr. GIBBONS. I have got two gas engine high driver units. But, you know, there is not a problem out there we couldn't fix ourselves, and what we really——

Mr. NELSEN. It comes down to a feeling of how do you define quality of life? How much consumption is good and how much is beyond that, and that is what really is the question.

If we don't consume as much as we did, we'd be in a depression.

Mr. GIBBONS. I think it is wonderful. I go around the United States and I now see the growth of these temporary storage places. I have rented a few of them, so I know what goes on in those places. Most people have all their junk that they don't know what to do with in their house stored in those places. They are paying maybe $100 a month to store things that they probably even forgot they had, and they will go out and buy some more. That is what seems to be happening.

Mr. NELSEN. The real opportunity is industrializing the world so that the demand over there will change our production from luxury to essentials that are needed around the world, that will create more trading partners.

Mr. GIBBONS. Well, I want to tell the gentleman from California, look out, Florida's on the warpath, too. We are up there seeing what we can get, and we are heading for the Pacific right after Canada, so we are going to follow the California motto and see what we can raise around the world.

Mr. JACOBS. Which State would you find the shakiest investment?

Mr. GIBBONS. Well, California would, obviously, take the stablest investments, the stabilization of investment.

Mr. WALKER. The word "stable" is open to interpretation.

Mr. GIBBONS. Well, I think you all have raised a lot of interesting issues here and you have given me a lot more speech material. I will try it out on some other people. I have learned just from sitting here and listening and I thank you, each and every one of you, for coming and helping us with the problem.

[Whereupon, at 1 p.m., the committee was adjourned, to reconvene at 10 a.m., Thursday, January 25, 1990.]

FOREIGN INVESTMENT IN THE UNITED STATES

THURSDAY, JANUARY 25, 1990

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
Washington, DC.

The committee met, pursuant to call, at 10:15 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman **ROSTENKOWSKI**. The committee will come to order. Today the Committee on Ways and Means continues its hearings on the issue of foreign investment in the United States. As I indicated in my opening remarks yesterday, these hearings are one in a series to consider issues of long-term importance to programs under the jurisdiction of this committee.

I wish to underscore the fact that this committee approaches the question of foreign investment with an open mind. The purpose of these hearings is to increase our understanding of the reasons for recent increases in the level of foreign investment and its implications for the U.S. economy and economic policymaking.

Our first witness this morning, Hon. Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, is in an excellent position to help the committee understand the many complexities surrounding the issue of foreign investment.

I am sure he will give us a greater insight into how this country's heavy reliance on foreign investment affects the ability of our key economic policymakers to undertake policy changes that they feel may be appropriate for purely domestic concerns.

He also can help us understand the steps that this country needs to take to reduce its dependence on foreign capital and regain tighter control over its economic future. I want to stress that the committee has invited Mr. Greenspan for the primary purpose of learning his views on the very important matter of foreign investment.

I respectfully encourage all members to focus their questions and remarks on the issue of foreign investment rather than on unrelated issues. Mr. Greenspan, you may proceed. The committee looks forward to hearing from you, and it is always nice to have you with us.

STATEMENT OF HON. ALAN GREENSPAN, CHAIRMAN OF THE BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. **GREENSPAN**. Thank you very much, Mr. Chairman.

I am pleased to appear before this committee today to discuss foreign investment in the United States. Over the past decade, foreign investment in the United States has increased dramatically, reflecting both the increased integration of world financial markets and the financial flows that are the necessary counterpart to large U.S. current account deficits. In my testimony today, I would like to put these developments in perspective and analyze their longer run implications. Both direct and portfolio investment by foreigners in the United States have soared in the past decade.

Statistics on foreign investments in the United States tell only part of the story of increased foreign participation in U.S. financial markets. This surge in cross-border financial transactions has paralleled a large advance in the magnitude of cross-border trade of goods and services. A key factor behind these trends in international trade and securities transactions is a process that I have described elsewhere as the "downsizing of economic output." The creation of economic value has shifted increasingly toward conceptual values with decidedly less reliance on physical volumes. Today, for example, major new insights have led to thin fiber optics replacing vast tonnages of copper in communications. Financial transactions historically buttressed with reams of paper are being progressively reduced to electronic charges. Such advances not only reduce the amount of human physical effort required in making and completing financial transactions across national borders, but facilitate more accuracy, speed, and ease in execution.

Underlying this process has been quantum advances in technology, spurred by economic forces. In recent years, the explosive growth in information-gathering and processing techniques has greatly extended our analytic capabilities of instituting ideas for physical volume. The purpose of production of economic value will not change. It will continue to serve human needs and values. But the form of output increasingly will be less tangible and hence more easily traded across international borders.

The share of GNP which is accounted by sheer physical volume is going down progressively and will continue to do so, and what it means essentially when one looks at the physical products we turn out, that in real value terms, that is, adjusted for inflation, what we find is that things are getting smaller and smaller, therefore easier to move and hence, easier to transport across national boundaries.

When we look at our underlying trade data, it shows up very dramatically. As I recall, the physical volume per real or constant dollar of imports and exports in this country is going down 3 to 4 percent per annum on average, and what that essentially means is we can put things on aircraft and move them much faster. We can move them by any sort of vehicle which means that the aggregate amount of exports and imports in our country is rising relative to our GNP and will continue to do so.

It should not come as a surprise therefore that in recent decades the growth in world trade has far outstripped the growth in domestic demand. As a necessary consequence, imports as a share of output on average has risen significantly. Since irreversible conceptual gains are propelling the downsizing process, these trends almost surely will continue into the 21st century and beyond.

New technology—especially computer and telecommunications technology—is boosting gross financial transactions across national borders at an even faster pace than the net transactions supporting the increase in trade in goods and services.

Portfolio considerations are also playing an important role in the globalization of securities markets. As the welfare of people in the United States and abroad becomes increasingly dependent on the performance of foreign economies, it is natural for both individual investors and institutions to raise the share of foreign securities in investment portfolios. Such diversification provides investors a means of protecting against both the depreciation of the local currency on foreign exchange markets and the domestic economic disturbances affecting asset values on local markets. As international trade continues to expand more rapidly than global output, and domestic economies become even more closely linked to those abroad, the objective of diversifying portfolios of international securities will become increasingly important. Moreover, since the U.S. dollar is still the key international currency, such diversification has been, and may continue to be disproportionately into assets denominated in the dollar.

Another factor facilitating the globalization of capital markets and the growth of foreign investments in the United States has been deregulation. Technological change and innovations that have tied international economies more closely together have increased opportunities for arbitrage around domestic regulations, controls, and taxes, undermining the effectiveness of these policies. Many governments have responded by dismantling domestic regulations designed to allocate credit and by removing controls on international capital flows, relying more heavily instead on market forces to allocate capital. An additional factor of contributing to an increase in Japanese gross investments abroad may have been the rise in stock and land prices in Japan that has been leveraged to finance these increased investments.

The 1980's were marked not just by the expansion of gross capital flows in and out of the United States but also by very large net capital inflows.

The growing U.S. net international indebtedness and our large current account deficits are two sides of the same coin. Over the past decade the United States bought more goods and services from the rest of the world than it sold and has paid for the differences, in essence, by borrowing from, and selling assets to, foreigners. The U.S. current account moved from approximate balance in the early 1980's to a deficit of more than $140 billion in 1987. More recently, the deficit has declined, but it remains substantial. The principal underlying cause of the surge in our net borrowing from foreigners and the deterioration in our external balance has been the substantial decline in our national savings rate against the background of a relatively stable domestic investment rate. As you are well aware, the decline in our savings rate reflected both the expansion of the fiscal deficit and some down trend in the U.S. private savings rate. The fundamental accounting identify between savings and investment, of course, requires that any shortfall of domestic savings below domestic investment be made up in the form of a net inflow of savings from abroad.

The widening of the U.S. external deficit also was facilitated by the enhanced mobility of capital; the tremendous growth in gross capital flows undoubtedly permitted the emergence of very large netflows. On balance though, the global integration of financial markets was probably only a facilitating factor, not a motivating force, behind the growth and persistence of U.S. net capital inflows.

The progress that has been made in reducing the budget deficit from its earlier peak levels, along with declines in U.S. interest rates and the dollar since the mid-1980's can explain much of the more recent improvement in the external deficit. Nonetheless, we still have a long way to go to establish equilibrium in our international accounts.

The persistence of inadequate domestic savings, large current account deficits, and continued deterioration of the U.S. net international investment position remain matters of serious concern. Current U.S. savings levels are inadequate to finance the domestic investment necessary to provide rising living standards for future generations on the scale enjoyed by previous generations.

The most important contribution Congress can make to remedying this problem is to continue the progress made in recent years in reducing the Federal budget deficit. As I have stated here before, the ultimate target should be a budget surplus.

Efforts to limit directly or to discourage the inflow of capital from abroad would aggravate the problem by raising real interest rates in the United States and lowering domestic investment toward levels consistent with already low domestic savings. Even limited measures affecting only certain capital flows such as direct investment would necessitate larger inflows through other channels which could only be attracted at higher rates of return or with a weaker dollar.

Measures to restrict or discourage foreign investment in the United States would be undesirable for other reasons as well. The United States has benefited and will continue to benefit from the inevitably closer integration of world markets for goods, services, and capital. As unfolding events in Eastern Europe indicate, countries that attempt to isolate their economies from the rest of the world and do not heed market signals in allocating scare resources pay a high price in terms of low levels of economic welfare.

Concern about foreign investment in the United States tends to focus on direct investment; highly visible purchases, such as Rockefeller Center, Columbia Pictures, and Bloomingdales, have given rise to the fears about the selling of America at bargain-basement prices. However, little attention is paid to the benefits of direct investment. The operations of multinational companies play an important role in facilitating the growth of world trade in goods, services, and information. Trade and direct investment are intimately related; transactions between direct investment affiliates and their U.S. or foreign parents account for 35 percent of U.S. merchandise exports and 40 percent of U.S. imports in 1987—the latest year for which data are available.

It is essentially impossible to separate trade from investment and vice versa. Foreign investment in the United States spurs competition, provides infusions of new capital and technology into industries like steel, and speeds the spread of technological advances.

Nevertheless, concerns about direct investment in the United States are understandable because these investments sometimes disrupt established patterns of doing business. But on the whole such concerns are overblown. It is ironic that if a Japanese real estate company buys a building in the United States, we record it as a direct investment and a possible source of concern. If, however, the real estate company dismantles the building brick by brick and ships it to Japan, it is recorded as a United States export, a positive event.

Acquisitions of U.S. companies by foreigners present somewhat different issues. The analysis of merges and acquisitions in general is controversial, but one conclusion with which nearly all investigators would concur is that the American stockholders of takeover targets are big gainers. The former owners of acquired U.S. companies can reinvest these funds in other enterprises that they judge to have the highest returns. As for foreigners who outbid U.S. competitors for U.S. companies, recent news indicates that overly optimistic estimates of future earnings may have been an important factor in several important cases.

Most direct investment in the United States originates from the United Kingdom, Japan, Canada, the Netherlands, and Germany, countries with which the United States has close economic and political ties. Direct investment in the United States gives these countries an even larger interest in ensuring continued U.S. prosperity. Moreover, the U.S. Government has ample authority to block direct investments that have a negative impact on national security or that involve undesirable concentrations of market power.

In conclusion, the globalization of markets for goods, services, and finance benefits both the United States and the rest of the world. Efforts to insulate the United States from the inexorable forces of increasing globalization could be very costly to our standard of living. However, continued efforts should be made to limit risks in international payments and securities settlement systems and to protect investors by increasing international cooperation and coordination of supervision and regulation.

The United States could help to ensure the orderly progress of global integration by reducing its current account imbalance. The necessary policies are not those that attack the symptoms—large accumulations of foreign assets in the United States—but rather policies that address the underlying cause, which is our inadequate national savings, particularly our large Federal budget deficit.

Thank you very much, Mr. Chairman.

[The statement of Mr. Greenspan follows:]

STATEMENT OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

I am pleased to appear before this committee today to discuss foreign investment in the United States. Over the past decade, foreign investment in the United States has increased dramatically, reflecting both the increased integration of world financial markets and the financial flows that are the necessary counterpart to large U.S. current account deficits. In my testimony today, I would like to put these developments in perspective and analyze their longer-run implications.

Both direct and portfolio investment by foreigners in the United States have soared in the past decade. Since 1980 the position of foreign direct investors in the United States has increased by 300 percent. Private foreign holdings of U.S. Treasury securities have increased 500 percent and holdings of equities have increased 200 percent. Holdings of corporate and U.S. government agency bonds also have grown rapidly, as have liabilities of banks in the United States to foreigners; growth of the latter was spurred by regulatory changes in late 1981 that permitted the creation of International Banking Facilities.

These statistics on foreign investments in the United States tell only part of the story of increased foreign participation in U.S. financial markets. Foreign-based financial intermediaries play an increasingly prominent role in U.S. banking and securities markets. The volume of transactions by foreigners in U.S. securities markets has increased even more dramatically than foreign holdings. For example, foreign purchases and sales of U.S. Treasury securities surpassed $3 trillion on a gross basis in 1988, up from $100 billion to $200 billion earlier in the decade. Similarly, foreign purchases and sales of U.S. corporate stocks and bonds also have been running dramatically above levels earlier in the decade, although they are off from their peak levels of a couple of years ago.

U.S. investment abroad also has grown in the 1980s, but not as rapidly as foreign investment in the United States. Although the position of U.S. direct investors abroad as measured by book value increased by about 50 percent between the end of 1980 and the end of 1988, the book value of foreign direct investment in the United States rose from much lower levels to about the same total -- $325 billion as of the end of 1988. However, the market value of U.S. direct investments abroad, which have accumulated over many years, undoubtly still exceeds the market value of foreign direct investments in the United States by a substantial margin. U.S. holdings of foreign stocks and bonds also have grown in the 1980s, as have the activities abroad of U.S. financial intermediaries.

This surge in cross-border financial transactions has paralleled a large advance in the magnitude of cross-border trade of goods and services. A key factor behind these trends in international trade and securities transactions is a process that I have described elsewhere as the "downsizing of economic output." The creation of economic value has shifted increasingly toward conceptual values with decidedly less reliance on physical volumes. Today, for example, major new insights have led to thin fiber optics replacing vast tonnages of copper in communications. Financial transactions historically buttressed with reams of paper are being progressively reduced to electronic charges. Such advances not only reduce the amount of human physical effort required in making and completing financial transactions across national borders but facilitate more accuracy, speed and ease in execution.

Underlying this process has been quantum advances in technology, spurred by economic forces. In recent years, the explosive growth in information-gathering and processing techniques has greatly extended our analytic capabilities of substituting ideas for physical volume. The purpose of production of economic value will not change. It will continue to serve human needs and values. But the form of output increasingly will be less tangible and hence more easily traded across international borders. It should not come as a surprise therefore that in recent decades the growth in world trade has far outstripped the growth in domestic demand. As a necessary consequence, imports as a share of output on average have risen significantly. Since irreversible conceptual gains are propelling the downsizing process, these trends almost surely will continue into the twenty-first century and beyond.

New technology -- especially computer and telecommunications technology -- is boosting gross financial transactions across national borders at an even faster pace than the net transactions supporting the increase in trade in goods and services. Rapidly expanding data processing capabilities and virtually instantaneous information transmission are facilitating the development of a broad spectrum of complex financial instruments that can be tailored to the hedging, funding, and investment needs of a growing array of market participants. These types of instruments were simply not feasible a decade or two ago. Some of this activity has involved an unbundling of financial risk to meet the increasingly specialized risk management requirements of market participants. Exchange rate and interest rate swaps, together with financial futures and options, have become important means by which currency and interest rate risks are shifted to those more willing to take them on. The proliferation of financial instruments, in turn, implies an increasing number of arbitrage opportunities, which tend to boost further the volume of gross financial transactions in relation to output. Moreover, these technological advances and innovations have reduced the costs of managing operations around the globe, and have facilitated direct, as well as portfolio, investment.

Portfolio considerations also are playing an important role in the globalization of securities markets. As the welfare of people in the United States and abroad becomes increasingly dependent on the performance of foreign economies, it is natural for both individual investors and institutions to raise the share of foreign securities in investment portfolios. Such diversification provides investors a means of protecting against both the depreciation of the local currency on foreign exchange markets and the domestic economic disturbances affecting asset values on local markets. As international trade continues to expand more rapidly than global output, and domestic economies become even more closely linked to those abroad, the objective of diversifying portfolios of international securities will become increasingly important. Moreover, since the U.S. dollar is still the key international currency, such diversification has been, and may continue to be, disproportionately into assets denominated in the dollar.

Another factor facilitating the globalization of capital markets and the growth of foreign investments in the United States has been deregulation. Technological change and innovations that have tied international economies more closely together have increased opportunities for arbitrage around domestic regulations, controls, and taxes, undermining the effectiveness of these policies. Many governments have responded by dismantling domestic regulations designed to allocate credit and by removing controls on international capital flows, relying more heavily instead on market forces to allocate capital. An additional factor contributing to an increase in Japanese gross investments abroad may have been the rise in stock and land prices in Japan that has been leveraged to finance these increased investments.

The 1980s were marked not just by the expansion of gross capital flows in and out of the United States but also by very large net capital inflows. As I noted earlier, foreign investment in the United States has grown faster than U.S. investment abroad. During the decade of the 1980s, the U.S. net international investment position, as published by the Department of Commerce, fell sharply from a positive $141 billion at the end of 1981 to a negative $533 billion by the end of 1988. However, these numbers should not be viewed as precise measures of U.S. net international indebtedness. Because of valuation problems in the U.S. international transactions accounts, the measurement of U.S. indebtedness could be overstated by several hundred billion dollars. Much of this overstatement is the result of the inclusion of direct investment assets in the data at book rather than market value. Nonetheless, while the precise level of our net investment position is uncertain, the direction and magnitude of recent changes are clear. They are the consequence of our large current account deficits.

The growing U.S. net international indebtedness and our large current account deficits are two sides of the same coin. Over the past decade the United States bought more goods and services from the rest of the world than it sold and has paid for the difference, in essence, by borrowing from, and selling assets to, foreigners. The U.S. current account moved from approximate balance in the early 1980s to a deficit of more than $140 billion in 1987. More recently, the deficit has declined, but it remains substantial.

The most important underlying cause of the surge in our net borrowing from foreigners and the deterioration in our external balance has been the substantial decline in our national savings rate against the background of a relatively stable domestic investment rate. As you are well aware, the decline in our savings rate reflected both the expansion of the fiscal deficit, and some downtrend in the U.S. private savings rate. The fundamental accounting identity between savings and investment, of course, requires that any shortfall of domestic savings below domestic investment be made up in the form of a net inflow of savings from abroad.

It is important to understand just how this link between lower domestic savings and increased inflows from abroad worked in practice. The increased demand for funds to finance both the gaping budget deficit and growing private investment in the face of a declining private savings rate put substantial upward pressure on U.S. interest rates. Higher interest rates made investment in the United States more attractive to foreigners, increased demand for dollars to implement such investments, and, thereby, pushed up the foreign exchange value of the dollar. The higher dollar in turn reduced U.S. international price competitiveness and contributed to the widening of the external deficit. The fiscal stimulus and downtrend in private savings also led to strong growth in U.S. domestic demand, which raised demand for imports and contributed further to the external deficit.

The behavior of U.S. national savings rate during most of the 1980s contrasted with events abroad. Over much of the past decade, other major industrial countries generally were moving fiscal policies toward restraint. In Germany and Japan, especially, government deficits were being reduced, which contributed to their external surpluses and the outflow of financial resources from those countries.

The widening of the U.S. external deficit also was facilitated by the enhanced mobility of capital; the tremendous growth in gross capital flows undoubtedly permitted the emergence of very large net flows. On balance though, the global integration of financial markets was probably only a facilitating factor, not a motivating force, behind the growth and persistence of U.S. net capital inflows.

The progress that has been made in reducing the budget deficit from its earlier peak levels, along with declines in U.S. interest rates and the dollar since the mid 1980s can explain much of the more recent improvement in the external deficit. Nonetheless, we still have a long way to go to establish equilibrium in our international accounts.

The persistence of inadequate domestic savings, large current account deficits, and continued deterioration of the U.S. net international investment position remain matters of serious concern. Current U.S. savings levels are inadequate to finance the domestic investment necessary to provide rising living standards for future generations on the scale enjoyed by previous generations.

The most important contribution Congress can make to remedying this problem is to continue the progress made in recent years in reducing the federal budget deficit. As I have stated here before, the ultimate target should be a budget surplus.

Efforts to limit directly or to discourage the inflow of capital from abroad would aggravate the problem by raising real interest rates in the United States and lowering domestic investment towards levels consistent with already low domestic savings. Even limited measures affecting only certain capital flows such as direct investment would necessitate larger inflows through other channels which could only be attracted at higher rates of return or with a weaker dollar.

Measures to restrict or discourage foreign investment in the United States would be undesirable for other reasons as well. The United States has benefitted and will continue to benefit from the inevitably closer integration of world markets for goods, services, and capital. As unfolding events in Eastern Europe indicate, countries that attempt to isolate their economies from the rest of the world and do not heed market signals in allocating scarce resources pay a high price in terms of low levels of economic welfare.

The globalization of capital markets offers many benefits in terms of increased competition, reduced costs of financial intermediation benefiting both savers and borrowers, more efficient allocation of capital, and more rapid spread of innovations. However, this internationalization does pose certain risks as well: the United States has become more vulnerable to disturbances originating outside its borders. The Federal Reserve has been actively interested in efforts to limit risks in international payments and settlement systems. In cooperation with authorities in other countries, the Federal Reserve has pressed for improved capital adequacy for banks and other financial intermediaries.

These measures to protect the soundness and integrity of our financial system are necessary regardless of whether the United States is a net debtor or creditor. It should be noted that in the 1970s, when the United States was still a substantial net creditor, unfavorable developments led to repeated episodes of downward pressure on the foreign exchange value of the dollar. Given the vast array of financial products currently available, and the wealth of U.S. residents themselves, the size of net holdings by foreigners of U.S. assets bears little relationship to the magnitude of pressures that can arise in foreign exchange markets.

Concern about foreign investment in the United States tends to focus on direct investment; highly visible purchases, such as Rockefeller Center, Columbia Pictures, and Bloomingdales, have given rise to fears about the selling of America at bargain basement prices. However, little attention is paid to the benefits of direct investment. The operations of multinational companies play an important role in facilitating the growth of world trade in goods, services, and information. Trade and direct investment are intimately related; transactions between direct investment affiliates and their U.S. or foreign parents accounted for 35 percent of U.S. merchandise exports and 40 percent of U.S. imports in 1987 -- the latest year for which data are available. It is essentially impossible to separate trade from investment and vice versa. Foreign investment in the United States spurs competition, provides infusions of new capital and technology into industries like steel, and speeds the spread of technological advances.

Concerns about direct investment in the United States are understandable because these investments sometimes disrupt established patterns of doing business. But on the whole such concerns are overblown. It is ironic that if a Japanese real estate company buys a building in the United States, we record it as a direct investment and a possible source of concern. If, however, the real estate company dismantles the building brick by brick and ships it to Japan, it is recorded as a U.S. export, a positive event.

Acquisitions of U.S. companies by foreigners present somewhat different issues. The analysis of mergers and acquisitions in general is controversial, but one conclusion with which nearly all investigators would concur is that the American stockholders of takeover targets are big gainers. The former owners of acquired U.S. companies can reinvest these funds in other enterprises that they judge to have the highest returns. As for foreigners who outbid U.S. competitors for U.S. companies, recent news indicates that overly optimistic estimates of future earnings may have been an important factor in several important cases.

Although foreign direct investment in the United States has grown very rapidly, it is still relatively small. For manufacturing as a whole, direct investment affiliates accounted for 13 percent of assets and 11 percent of sales in 1987, the latest data available. Comparison of the role of direct investment affiliates in U.S. sales, manufacturing employment, and assets with ratios for other countries indicates that direct investment plays a much smaller role in the U.S. economy than in Canada, the United Kingdom, Germany, or France.

Most direct investment in the United States originates from the United Kingdom, Japan, Canada, the Netherlands, and Germany, countries with which the United States has close economic and political ties. Direct investment in the United States gives these countries an even larger interest in ensuring continued U.S. prosperity. Moreover, the U.S. government has ample authority to block direct investments that have a negative impact on national security or that involve undesirable concentrations of market power.

Comparison of the operations of affiliates of foreign companies with U.S. firms in the same industry indicates that R-and-D expenditures, wage rates, and value added do not differ systematically. Only a tendency to import more clearly distinguishes affiliates from U.S.-owned companies; however, since some foreign companies have built plants in the United States to replace imports, the net effect of direct investment on the U.S. trade balance is probably small.

One area of foreign direct investment of particular interest to the Federal Reserve Board is the banking industry. Foreign banks account for about one-fifth of all banking assets in the United States. However, in many cases foreign banks conduct largely international transactions at their U.S. offices. Foreign-chartered banks typically have not been very successful at competing for retail U.S. business, but they have been more successful in the area of commercial and industrial lending to large companies. Foreign bank participation in that market has increased competitive pressures to price loans off money market rates. U.S. consumers of banking services have benefitted from a more competitive banking environment. Departure from a policy of national treatment in the banking industry could produce retaliation and could seriously complicate negotiations to ensure access of U.S. banks to markets abroad, particularly to Europe after 1992.

In conclusion, the globalization of markets for goods, services, and finance benefits both the United States and the rest of the world. Efforts to insulate the United States from the inexorable forces of increasing globalization could be very costly to our standard of living. However, continued efforts should be made to limit risks in international payments and securities settlements systems, and to protect investors by increasing international cooperation and coordination of supervision and regulation.

The United States could help to ensure the orderly progress of global integration by reducing its current account imbalance. The necessary policies are not those that attack the symptoms--large accumulations of foreign assets in the United States -- but rather policies that address the underlying cause, which is our inadequate national savings, particularly our large federal budget deficit.

Chairman ROSTENKOWSKI. Thank you, Governor.

The dilemma of our time, I am sure you will agree, is the personal savings decline in this country. Is there anything, Mr. Greenspan, that you could recommend with respect to the Tax Code that we could do? IRA's, when they were initiated, showed a rise in personal savings, but then again you don't know whether that is just money being shifted from one account to another.

There is no question that our biggest problem in this country is the deficit, and our unwillingness to face the problem of reducing that. I just wonder whether there was anything specific that you could recommend to this committee that we do in the Tax Code that would persuade our constituencies to invest personal income.

Mr. GREENSPAN. Well, Mr. Chairman, I think the evidence on the ability of IRA's to increase net domestic savings is mixed. There was earlier fairly general agreement that it probably did not significantly increase domestic savings.

A number of recent studies, based on analyses of the statistics of income and the IRS returns for individuals for recent years, has at least brought that issue to a more controversial level as to whether in fact it may have.

I, myself, don't find the evidence particularly conclusive one way or the other. But I think there is still some possibility that IRA's, appropriately constructed, may well increase total domestic savings.

But having said that and having been aware, as you have, Mr. Chairman, the numbers of years, perhaps decades that we have been focusing on this issue with some degree of chagrin at the results that have occurred, I am led to conclude that while it is certainly most appropriate to continue to look to means in the Tax Code for improvements in total net domestic savings, that we should focus increasingly on something which we know will increase domestic savings—that is getting the budget deficit down, eliminating the drain on private savings. While I would say at this stage that there probably are vehicles out there which will appropriately address the subject, I think we, however, don't have the time to focus on this indefinitely into the future. Whether or not we come up with vehicles which work or not, I think should be an issue which is secondary to confronting this deficit problem, which is at the root of a lot of our problems in this area.

Chairman ROSTENKOWSKI. I couldn't agree with you more, Mr. Greenspan. On another subject, I am concerned about the budgetary treatment of the Resolution Trust Corporation and the need for working capital.

How should working capital be treated in the budget, Mr. Greenspan?

Mr. GREENSPAN. I would say wholly off-budget and not so much because of the fact that the initial moneys that come on budget would artificially increase the actual deficit. I am more concerned about when the working capital reverses and comes back into the Treasury that would, if it is on budget, reduce the unified budget deficit and give us a view of the size of the problem which confronts us, which I think would be distorted.

Remember that by definition, working capital is revolving moneys which will ultimately come back to the Treasury, in fact, to the American taxpayer down to the last cent.

To the extent that it does not, it is a loss, and chargeable not to the working capital but basically to that $50 billion fund which was part of FIRREA's funding of the so-called savings and loan hole.

There are many different ways in which that working capital can be raised, Mr. Chairman, but with respect to the form in which it is handled, I certainly trust that we will not allow it to distort the evidences of the important trends in the unified deficit which directly relate to savings in the economy. The movements of working capital in the RTC have zero effect on net domestic savings. I would say as a general principle, since our concern about the unified budget deficit or more exactly our concern about the budget deficit generally at root relates to savings, then we should make certain that the bookkeeping of the deficit truly reflects that system. In fact, most economists who look at the system of savings and investment and the budget deficit don't even employ the unified deficit. What they employ is a national income accounts deficit, and that surely would exclude any movements of capital of any type.

Chairman ROSTENKOWSKI. Mr. Pease will inquire.

Mr. PEASE. Thank you very much, Mr. Chairman, and thank you Chairman Greenspan for being with us, and, again, being willing to share your wisdom on economic matters. I think we certainly benefit from having your counsel, now, as we have in the past.

Recently the Federal Reserve has been under some pressure to lower interest rates in order to spur economic growth or to avoid a slide in the economy.

Could you tell us how, if you were to respond to that pressure and lower interest rates, that would impact on capital flows in the financing of our debt?

It seems to me if we lowered interest rates it would decrease even further the spread between our interest rates and those offered in, say, Japan and thereby make the United States a less attractive place in which to invest.

Am I wrong about that?

Mr. GREENSPAN. No, you are not wrong in the specific example which you gave. Obviously, there are innumerable elements in the world economy which affect what our policies are. I might say parenthetically, that—I know the press has indicated that we are being pressed by the administration. I think, frankly, that has been a little overblown, and I think it is more an issue of the President expressing his desire for lower real interest rates not offset by inflation, which would raise the level of investment in this country and capital investment in housing, and I think certainly that is a goal of economic policy.

The key question is basically how do we achieve those lower rates. What we are observing in recent days is the phenomenon which, as we have discussed in this committee before and in other committees; namely, that we are dealing in an international market and that there is a very significant amount of savings that are flowing into this country. They are flowing into this country to essentially finance our domestic investment because foreigners perceive that the rates of return here are superior to their own countries, whether that be profit or interest.

Obviously, as interest rates rise in Japan and in Europe relative to those in the United States, significant amounts of that capital which otherwise would flow to this country are diverted to those domestic economies, and I think we are seeing some of that pressure in the longer end of our bond market.

Mr. **Pease**. What is your feeling about the availability of Japanese capital to finance our deficits? A significant amount has come from Japan in recent years. There have been some changes, and indications in the last day or so in the sale of bonds to finance the savings and loan bailout that there is some less enthusiasm now than before.

Do you think we can look forward over the next few years to a continued availability of Japanese capital flowing into the United States to deal with our deficits?

Mr. **Greenspan**. Well, Mr. Pease, I think that the size of our current account deficit, which is a rough measure of how much capital we have to move in, how much savings we have to move in to finance it, is not going to decline very sharply.

Another way of putting that is that it need not decline all that sharply because it is very clear that foreigners consider investing in the United States, in our securities and in our domestic assets highly desirable.

The rate of return here is good. The political climate is clearly favorable to investment, and I think we will continue to see flows of investment into the United States pretty much as they have occurred in the context, hopefully, of a continuing decline in our current account deficit, I certainly hope our budget deficit moves down and allows more domestic savings to finance the level of domestic investment and, therefore, makes the need for foreign savings increasingly less over the years.

Mr. **Pease**. Thank you very much, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Coyne.

Mr. **Coyne**. Thank you, Mr. Chairman.

Mr. Greenspan, just to get back to the savings situation, don't savings incentives throughout the Tax Code benefit those individuals who are in a better position to save and probably are saving rather than the moderate- and low-income people?

Mr. **Greenspan**. It is certainly the case that a significant part of the savings in our private sector is in middle upper and upper income groups. I mean, they have the capability of saving.

But I think the effect at the margin is much more general throughout the income distribution, that is the so-called marginal propensity to save is different from these averages.

I think that we should even prefer to get an increase in savings in the society at all income groups. It is a cultural issue which we have to try to encourage. But let me just say that the advantage to the economy from getting that increased savings, thus increasing the overall levels of productivity in the economy, helps everybody. In other words, increased savings essentially raise overall standards of living and help all income groups. So while it is certainly the case that the initial effect probably is disproportionately in the upper income groups and the upper middle-income groups, the net effect on the well-being of the economy, to the extent that tax incentives actually create an improvement in net domestic savings, is across the board and is very helpful to all households at all income levels.

Mr. **Coyne**. I guess that is my point. The upper income people are going to be saving anyhow.

Mr. **Greenspan**. No, I agree with you on that. They do tend to save, but the question is will they save more. And that is the real test that we have to make with respect to a number of these proposals. It is still a controversial question.

Mr. **Coyne**. Thank you.

Chairman **Rostenkowski**. Mr. Thomas.

Mr. **Thomas**. Thank you, Mr. Chairman. Thank you, again, Mr. Chairman, for reminding us that it is true that almost everything we need to know we learn in kindergarten, but we tend to forget it, and that is we should deal with primary things first, and although this committee wants to focus on the Tax Code, that we should continue to focus on dealing with the budget deficit.

Now, having understood that primary lesson once again, could you give me some indication, if you would, as to your preferences, not necessarily personal, but from an economic point of view dealing with foreign trading as to how we deal with reducing the deficit? That is, is it more important for us in continuing to try to posture ourselves in a better position to deal with reducing the deficit in a particular way or is it less important how we deal with the deficit but that we deal with it, that is, spending is important, raising taxes is important, the mix may be important or is it not, and that is, get on with reducing the deficit and worry less about how you do it?

Mr. **Greenspan**. Well, Mr. Thomas, I think when we talk about reducing the deficit, let's make sure that what we are talking about is not just fiscal 1991 or even fiscal 1992. The savings problem that we have is a long-term problem and thus our focus on the deficit has got to be in the context of 5, 7, even 10 years. In this context I think it is important to recognize, as I have said to this committee before, that there is a risk that if you try to close the deficit from the tax side that, while it may appear in the very short run to create significant reductions in the deficit, there is, as far as I can judge, a propensity to spend tax revenues, which probably means that over the longer run, large increases in taxes for the purpose of reducing the deficit will probably be quite inefficient.

To the extent that one can bring the deficit down by expenditures, over the long run I think the results will be more lasting and more beneficial to the underlying savings of the system. So I would say there is clearly a bias in terms of how one comes at this issue if the purpose is just strictly will it work or will it not work. And, I would be most inclined to put disproportionate emphasis as best we can on cutting spending.

Mr. **Thomas**. So once again, a simple lesson, not just living within your means, reducing consumption and focusing on being prudent.

Thank you very much, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Levin.

Mr. **Levin**. Welcome.

There is reference here to the interest rates in Japan and what that might trigger. As you worry every day, if not every hour as we look at the economic picture internationally, what is the flash point that might worry you the most? What sign concerns you?

You addressed the interest rate increase in Japan.

Mr. **Greenspan**. You know, Mr. Levin, when I was a private economist I could answer questions like that. I have learned since I am in my present job that I don't even dare because, you know, if you sit there and you worry about things—you are quite right, we worry about everything—I have learned that when you worry you try to correct what you think is out of balance, but the less you talk about it, I think the better off we are.

Mr. **Levin**. Well, I tried. I am not doing it——

Mr. **Greenspan**. No, no——

Mr. **Levin**. I am not doing it for any reason except as it relates to policy, and I guess I was also asking you the question to get some feeling as to how perilous you think the present situation is.

We read this morning, we heard this morning about the increase in interest rates in Japan and the kind of effect it might have, the kind of billiard table effect, one ball hitting another, and I know the last thing you want to do is to sound the alarm, but maybe you could give us some idea of warning signals.

Mr. **Greenspan**. Let me say this, Mr. Levin, I think that as globalness of markets increases and as I have indicated in my prepared remarks, I think that we are in the process of an inevitable expansion of economic forces around the world and the ability of individual countries at their borders to block goods and services information, even political theories is going to become increasingly less possible. Implicit in that is what will be perceived to be more instability.

In other words, people don't like competition. I mean, it makes us uncomfortable. It disrupts our natural way of behaving and it gives us a sense on occasion that something is out of control or is about to crash or is unstable or broken down, and I think that what events in recent years have indicated to us is that this is not correct.

Instead of instability, the concern that a lot of people have is merely a reflection of the fact of the increasing global savings flows and not necessarily of true fundamental imbalances which are about to break loose.

So I think it is important not to exaggerate this issue as it is easy to do because there are some things that are going on that are different from where they were 20, 30, 40 years ago. I think we have a tendency to look at this process as a forerunner to some form of breakdown. I don't think it is.

What we are looking at is a process of change and, indeed if it is anything, it is growth.

Mr. **Levin**. When you say that I think the danger is that it is heralded as a reason for inaction. Let me just, in that regard, though, ask you quickly, do you think it matters at all who owns what in America?

Mr. **Greenspan**. Oh, yes, it does matter because, obviously, to the extent that properties are profitable, the owners that have property will receive the income from it, and I must say I would prefer that it be Americans rather than non-Americans. But if you ask me does it affect the efficiency of the economy, does it affect wages, does it affect standards of living appreciably, then I would say the evidence suggests that it does not.

Mr. **Levin**. My time is up. Thank you.

Chairman **Rostenkowski**. Mr. Cardin.

Mr. **Cardin**. Thank you, Mr. Chairman.

Mr. Greenspan, I certainly appreciate your testimony here today. If I understand correctly, your testimony is that the balance between foreign investment in the United States and domestic savings is out of line, that we, as described yesterday by some of our witnesses are dependent upon, perhaps too dependent upon, foreign investment, and that there is now a narrowing of the advantage of investing in the United States versus some of our competing nations.

One of the consequences of that could be a reduction in the growth of our standard of living in this country. I am wondering if you could elaborate a little bit more as to what are the risks involved if we don't deal with the underlying problems of the savings ratios in this country, knowing full well that the congressional record when dealing with the deficit has not been that great, and the likelihood of dealing with it in 1990 is not very promising. What are the risks?

Mr. **Greenspan**. The risks are not imminent collapse or anything of that nature. The lack of savings to finance domestic investment in our economy is a corrosive force. In other words, if we, for example, did not have the flow of foreign savings to finance our domestic investment and the level of domestic investment therefore of necessity fell to the level of domestic savings, to the extent that investment affects standards of living and is a major force in that direction, we would be looking toward a significant slowing, perhaps even a stagnation in living standards.

What we would find is that the economy, instead of moving forward in line with the dynamism of the rest of the world, would be gradually falling behind. I don't think it implies any breakdown; I think it is a slow, corrosive, and a very insidious force, because you cannot say tomorrow, this is going to do this or that, but when you look at the process over a protracted period of time, its destructive forces are very evident.

Mr. **Cardin**. Let me follow Mr. Thomas' question. I am trying to deal with savings problems and the deficit. You have expressed yourself rather forcefully in favor of reducing Government spending, and we understand the difficulty of doing that.

You have expressed that we have a tendency of using new revenues. But to the extent that we look at new revenues, would it be better to look at consumption type revenues rather than the income type revenues.

Mr. **Greenspan**. Yes, I would think so. Clearly, to the extent that we are dealing with not only the absolute size of the claim of government on other private savings, but to the extent that certain types of consumption taxes, and I would say the one that strikes me as the most relevant would be a gasoline tax; to the extent that you curb consumption, you also tend to affect private savings as well as reduce the drain on the private savings that the Government deficit creates.

I have argued over the years, well before I was Chairman of the Federal Reserve, that the major reason for gasoline tax, however, would not even be the issue of the budget deficit, but rather what I think will over the years be the increasingly evident necessity to slow the growth of domestic oil consumption.

I think to the extent that we can do that because of our declining domestic production of oil, it would serve our overall savings and investment purpose quite importantly, because clearly, to the extent that we import significant amounts of oil, it affects our current account balances.

Mr. CARDIN. Thank you, Mr. Chairman.

Mr. GUARINI [presiding]. Mr. McGrath.

Mr. MCGRATH. Thank you, Mr. Chairman, and thank you, Mr. Chairman, for very good testimony today.

One of your statements, you said that we had ample authority to block unwanted or ill-advised foreign investments. We are under a lot of pressure here in the House to go along with a bill that would further impede foreign investment by providing for data. What is your reaction to that?

Mr. GREENSPAN. Well, as I said in my prepared remarks, Mr. McGrath, to the extent that we try to curb direct investment without changing our current account balance, it means that we have to finance that current account balance through other forms of foreign investment, and that almost surely will mean that U.S. real interest rates would have to rise, and that that would probably curb levels of economic activity in this county.

So, while it may achieve one purpose—I mean, if one perceives that curbing foreign direct investment is a benefit, which I must admit I do not, it is important to recognize that there are costs to the American people on the other side of that, and when contemplating such legislation, I think a full awareness of what one is doing on both sides of the issue I think is crucial.

Mr. MCGRATH. I couldn't agree more.

On—you have had a lot of questions on interest rates. I just want to know as a policy matter with the Fed, if a circumstance presented itself where we are at the point of having two successive negative quarters at which time a resolution could be presented here in the House and other places to do away with Gramm-Rudman for a year, what would be the policy in terms of the Fed in those terms regarding perhaps in a lowering of the rates so that we would not be presented with two successive quarters?

Mr. GREENSPAN. Mr. McGrath, it is very difficult for me to answer that question without getting into the details of interest rate policy, which I frankly would prefer to stay away from. In any event, how an economy evolves will determine Federal Reserve policy, and it can occur in the context which you suggest in so many different ways that I am not sure even if I wanted to tell you exactly what the Federal Reserve would end up doing, I actually could, because it would depend on a lot more than whether or not there were just two quarters of negative GNP growth.

There are so many other things going on at the same time that would be crucial to policy that I don't think you could get a constructive answer.

Mr. McGrath. My point was if reduction of the deficit is such an important aspect of our economy now, would you take that step in order to preserve the Gramm-Rudman apparatus?

Mr. Greenspan. All I will say is that I trust the Gramm-Rudman apparatus will stay in place. As awkward as it is, as difficult as it is, it is the only game in town, and it does have the capability of working as we observed in recent months.

I thought that the permanent sequestered element of the last agreement was a quite positive step which I don't think would have occurred without a Gramm-Rudman process.

Mr. McGrath. One last question: Looking at the economy of the Nation as it applies to various geographic sectors, are any regions of our country being disproportionately disadvantaged now because of the deficit and other economic situations?

Mr. Greenspan. That is a good question. I frankly haven't thought of it in those terms. I mean, generally, I would say that the existence of the deficit has created a higher real interest rate throughout the economy than otherwise would be the case, and to the extent that there are differences of capital intensity region by region, there would be some effects.

But my overall conclusion would be that this country is sufficiently homogenous and the movement of goods and services across State and regional boundaries unimpeded, that the regional effects from the deficit per se, I would say, are probably more general—actually more nationwide than they are regional-specific.

Mr. McGrath. Thank you for your testimony.

Mr. Guarini. That was not an easy question.

Mr. Dorgan.

Mr. Dorgan. Thank you very much, Mr. Chairman.

I have a suspicion that you are giving the President and Congress credit that we may not deserve on the Federal budget deficit. You indicate that the pivot point on the international question is the budget deficit. I might observe that the budget deficit in the budget this year is about $210 billion. Only by reaching over and grabbing the Social Security receipts above expenditures are we able to portray a budget deficit in the operating budget that looks better.

That is accomplished by the technique in Gramm-Rudman to bring the revenues back in. I would like to say that we are making great progress, but you were on the Commission and I agreed with you, to enforce substantial savings for the Social Security. Only by using those can we claim progress on the deficit.

Would you disagree with that?

Mr. Greenspan. No, I think that is an arithmetical fact. I do say, however, that if the Gramm-Rudman process were not available, I would say that the operating deficit in those terms would be worse, and to the extent that it has been brought down from the trajectory which it had been on, I would say that that progress has been made.

There is also a technical problem in that split which is not too important now, but which will become increasingly so. In the non-

Social Security, the so-called operating deficit, are the interest payments on the trust funds in Social Security. When those trust funds become very large, there is an increasing, very large, amount of intragovernmental interest payments which increase the Social Security surplus and increase the non-Social Security deficit.

So, in a sense, subtracting one from the other creates a partial accounting illusion which I think is part of the problem that we deal with when we separate these two.

Mr. **Dorgan**. The current real illusion to the extent that is not a contradiction is that the budget deficit in the operating budget is truly not getting better. You are suggesting the trajectory which was upward has now leveled off and therefore, things are better.

But leveling off at a couple hundred billion a year and adding $1 trillion to the debt in a few years is still troubling to the rest of us.

Mr. **Greenspan**. I couldn't agree with you more. I am troubled by that as well.

Mr. **Dorgan**. Let me ask you: You were concerned about the Federal deficit and the lack of savings that results from that. In the private sector, many of us have been very concerned about a blizzard of activity in recent years in hostile takeovers and mega-mergers financed and fueled by debt; junk bonds and an area called highly leveraged transactions in bank debt.

I am wondering whether we will expect to see any more aggressive behavior by the Fed to deal with what seems to us to be just a blizzard of activity in speculation. Wall Street high rollers, trying to divide up the current economic pie for their own advantage and fueling it all with debt, some of which is bank debt and defined as highly leveraged transactions.

Is the Federal Reserve Board considering doing anything more in those areas to dampen the speculation?

Mr. **Greenspan**. Remember what our role is in this context. It is to make certain that the commercial banks which are under our supervisory jurisdiction do not create—do not accumulate assets which are risky or—I will put it this way—unduly risky.

Banking is a risky business. In banking, you have to have risky assets. But we have looked at this in considerable detail. We will continue to look at it and monitor it on a bank-by-bank basis, as indeed I think we should. I believe much the same can be said about the Comptroller of the Currency and FDIC and the other major regulators.

Mr. **Dorgan**. Somewhere around $92 to $100 billion in loans added to the commitments, around $173 billion in loan commitments by banks involved in leveraged buyouts. In light of what we have had to do in the S&L industry, and in light of the risk assets owned by savings and loans, are you concerned about so-called junk bank debt rather than junk loans?

The level of them and what that might mean to us?

Mr. **Greenspan**. Oh, yes; in fact, we have been, and we have instituted regulations and specific guidelines that we believe will address that issue.

I might say parenthetically that a concern that I would have in this whole area is the fact that what we are doing is converting equity to debt. It is not so much the issuance of junk bonds or debt per se, but what concerns me most is the fact that we are shifting the leverage in the corporate sector, and that is reflected in a very significant reduction in the area of $100 billion a year in net equity in the system.

I think that that is the main area where I should hope that we can find means to alter. That is one of the reasons why I believe the Treasury is looking at the question of double taxation of dividends and a variety of other issues.

Mr. DORGAN. Are you looking in terms of highly leveraged transactions with banks involved in LBO's and hostile takeovers? Are you looking on an institution basis? Or are you looking at it in terms of the whole banking industry? Is there a level at which you become concerned industrywide?

Mr. GREENSPAN. I don't think that there is an industry number per se, because it is individual banks that are in trouble or get into trouble. I think it is important to be bank-specific in this case, because we can think in terms of some global number, and so long as we are short of that, we feel relaxed, and find out that there are a number of banks in very serious trouble even at the low level of aggregate LBO or highly leveraged transactions.

I think that if we can—if we can appropriately supervise individual banks, the total will take care of itself.

Mr. GUARINI. Thank you.

Mr. Chairman, as always, you have been very helpful in giving us the broad picture in trends, and we appreciate it. We have to make some very hard choices on the Budget Committee, choices on priorities. I think OMB and CBO are more apart than ever, $48 billion, and we have to get down 36 additional billion dollars to reach a baseline of $64 billion, going toward that Gramm-Rudman goal.

Of course, the issue of new entitlements come on the line. We talk about child care and extended home care and catastrophic medicine. There are many initiatives that are very important to our country. Yet at the same time, the balancing of the budget is a most important priority if we are to become competitive and if we are going to get our trade balance in order, and if we don't have to keep all our money from abroad all the time to balance our fiscal shortcomings.

If you had to make the hard choice between balancing the budget or entering into new entitlement programs at this time, where would you come down, and would you think that it would be more propitious to fight those entitlement battles at a later date, so if you have a sound economy now, you can truly take care of the children and the seniors and the people of tomorrow?

Mr. GREENSPAN. I couldn't answer it in phrases better than you just uttered, Mr. Chairman. I think that the best entitlement program that we can create for the American people is a sound economy, and to the extent that we can create higher levels of savings that go into domestic investment and therefore higher levels of capital stock and productivity, we have essentially the type of economy which throws off by its very nature the types of benefits which we would never produce through Federal programs.

Mr. GUARINI. So, it is singly more important to balance our budget than to do any other single thing this year. Would that be the first priority?

Mr. Greenspan. Yes; I would say that the primary national goal, from an economic point of view, would be to address that issue as quickly and as fully as possible.

Mr. Guarini. I hope the Budget Committee is listening this morning.

In regard to savings which is more critical, the chairman of our committee has said is the most troublesome thing, we more or less induce consumption. We promote consumption. Our advertisers do a great job of making sure we do, and so do our tax laws.

We have tried the IRA, and then we repealed it and said it was just moving the money around, and it wasn't saving that much money. Now we are talking about bringing it back again. We are talking about capital gains which have been going up and down, and there is a question as to whether it gives a faster velocity of money and if that is expansion-oriented.

Are we on the wrong tax system? Is the income tax so structured and is the income tax so endemic to not save the money that unless we change our approach that no laws that we will ever be able to devise or incentives that we will be able to put together will get us back into a saving mode?

Mr. Greenspan. No, I wouldn't say that, Mr. Chairman. I think that in our past, we have saved significant amounts of our income even with income tax progressivity greater than we have today. I don't deny that shifting from income taxes to consumption taxes probably would, other things equal, increase the savings rate.

But I wouldn't try essentially to fine-tune this issue to a point where what we are trying to do is incrementally improve savings through restructuring the tax system. There is a great deal of academic work which is in the area of increasing savings by going fully to consumption taxes and eliminating other forms, specifically income taxes.

I suspect that the academics are right in a mechanical sense, but I think that there are lots of other considerations in a democratic society which keeps the system going and keeps everybody moving in the same direction such that I think you have to consider issues of equity and politics, in the appropriate sense of the word, in making decisions of that nature if one's goal is to have a long-term fundamental improvement in the savings rate.

Mr. Guarini. Would we be better off in the long term to gradually move to a tax on consumption through excise taxes, et cetera, instead of getting the income we get from direct taxes, income taxes?

Mr. Greenspan. Yes, I would say that gradual changes would, probably, other things equal, increase the savings rate, and to the extent, if it is accepted by the society, it is probably to the good.

Mr. Guarini. Lastly, let me ask you in foreign investments, where you painted a picture that there are many advantages such as job opportunities, technology, that would bring an economic plus to our country. You also said that there is no fear, worry of foreign investments in our country, it is just part of the new global picture that has developed.

I understand that. But is there a point where we should be concerned about losing our economic sovereignty? Is there a point where the money would have an influence on our political process that would be worrisome, and should we track this money where we aren't tracking it now?

What are your thoughts, Mr. Chairman?

Mr. GREENSPAN. Let's remember that with the exception of Japan, which has very minor amounts of foreign investment in their economy, we are relatively low compared with Europe, for example, where the share of assets held by foreigners is much higher than it is here, and it is obviously the case, as we are acutely aware, in Canada.

The basic problem that we have is that it does disturb people to be confronted with changing patterns of business behavior and foreign direct investment does tend to change business patterns one way or another, although I must say to you that when you examine the average foreign-owned firm, it looks very much like domestic firms with respect to average behavior. In fact, they do a little more research and development. They probably import a shade more than the average firm. But the productivity, the nature of the firm is really quite American, if I may say that. I think that we probably should recognize that these are inexorable forces.

We will be increasing our direct investment abroad. We, for example, in recent years, have very significantly increased capital expenditures of the American affiliates in Europe. These are big forces in Europe. We are major players throughout the world.

I think what we are seeing is this: I guess the equivalent of the fact of this economic downsizing, which I was mentioning before about things getting smaller, the geometric equivalent of that is to shrink the globe. I think that is what is happening.

Mr. GUARINI. But at one time, we expended our gold; now we are expending our factories. Is there a point that you as chairman of the Federal Reserve Board would be concerned about the foreign investment getting too large in our country? Or would that point never be reached?

Mr. GREENSPAN. I am concerned at any level to the extent that I would prefer that our assets be owned by Americans rather than non-Americans in the sense that the income from those assets become American income rather than foreign income.

Mr. GUARINI. But should we track this?

Mr. GREENSPAN. Well, I think we do. We know as much as we need to, I think, with respect to these data. I am not certain that increasing the supply of information in any material sense is going to essentially alter our perception of what is basically going on.

Mr. GUARINI. But twice the bill had failed to track these kinds of investments. We don't even want to track bonding and bonds that are invested in the United States that are picking up our shortfall in our debt. What is the fear of tracking?

Mr. GREENSPAN. I think the concern—I don't think there is a fear—I think the obvious question is why. There is a concern that if the purpose was strictly to pick up data for purpose of looking at it, I don't think anybody would be worried except that the cost of doing it is not insignificant.

Mr. GUARINI. Otherwise, you would do it?

Mr. GREENSPAN. Well, I would say this: My concern would be that that would be step number one in legislation or actions which would impede foreign investment in the United States, which I think essentially would be detrimental to the American people.

Mr. GUARINI. All right, thank you, sir.

Mrs. Johnson.

Mrs. JOHNSON. Thank you, Mr. Chairman.

Welcome, Chairman Greenspan, and thank you for your very thoughtful and interesting remarks and the dialog that has followed them. My questions went to the same issue that my colleague, Mr. Guarini, just pursued.

So, I do want to just pursue that a little further. I was interested that you said that you think we are receiving adequate data. Maybe the problem then is the data that you receive reaches the data that can be made public to us and by us.

In light of the sensitivity of our economy to international capital-flows, it is important that the issue of foreign investment be one that elected representatives can deal with effectively with their constituents. I would have to say that I feel an inadequacy of information in this area.

I think part of the problem is that some of the information that the Department of Commerce collects, they cannot reveal to me. Perhaps that is the whole problem. But when I read, for instance, that more information is made public under OCD than it is in the United States, it leads me to believe that there is a problem with data or at least what we can use publicly, and we will not be able to manage this issue in a way that will sufficiently acknowledge the sensitivity of our economy to foreign investment if we do not have adequate data.

My specific question to you is: In your experience, is the data that is generally being collected by Government data that we ought to be able to use publicly? And do you believe that using it publicly would have no impact on capital flows?

Mr. GREENSPAN. I think you are quite correct in saying that the data that are collected by the Department of Commerce are quite detailed and project-by-project, individually, in fact the type of information that you are addressing.

The reason why the data are not made public in detail is because of the confidentiality issue that is involved in the collecting of those data, and since the vast proportion of the data we collect in Government is voluntary, our ability to collect the data in the voluminous form which we collect it very significantly rests on our ability to ensure the individual firms that those data will not be made available publicly, because they are in many instances of competitive value.

That is, they do indicate certain aspects of various different types of investments, the information of which is of economic value to the individual firm. If it were made public, it is almost like losing a patent or copyright. It is not, but it is a piece of economic inside information which has its value.

A crucial problem lies at that point in the process.

Mrs. JOHNSON. I agree with you that there is information that is like a trade secret that we don't want to require to be public, but if we used as a standard the kind of information that is disclosed in other markets, would there be any harm in that? Do you see any problems with changes that did not exceed disclosure requirements in other markets?

Mr. GREENSPAN. Mrs. Johnson, you are raising an issue which I am not sufficiently competent in at the moment that I would want to give you an off the top of my head judgment. I have used the data in great detail over the years and there is a lot more in those data than appears directly on the surface.

A great deal of it is inferable by showing relationships and the like. There are many instances where we publish A and B and if A plus B equals C, we don't publish C, but you could still infer it if you can pull the data out.

But you are pointing to, I think, where the problem lies. I think that in that principle I think that should be explored.

Mrs. JOHNSON. Thank you.

Thank you, Mr. Chairman.

Mr. GUARINI. Mr. Moody.

Mr. MOODY. Thank you.

Mr. Greenspan, Mr. Chairman, I would welcome your opinion on an issue slightly related, not directly related, to foreign investment. It is whether or not we should require foreign holders of American securities to be subject to withholding taxes. It seems to me that there has got to be a tremendous loss of revenue through noncompliance.

Mr. GREENSPAN. You mean on foreign holdings of U.S. securities?

Mr. MOODY. Right. Not directly related to foreign investment, but it is a related issue. It is partly an information issue. We don't know who owns them or don't know who has them, it is maybe harder to collect.

Mr. GREENSPAN. Let me say this. I think that you run into a difficult dilemma. I have no reason to disbelieve what a number of people say, that the compliance may be less than 100 percent on that, but I am almost certain that to the extent that you achieve full compliance, the aggregate amount that will be involved will come down sharply. So I think what we have to trade off here is the issue of tax revenues against foreign portfolio investment, which in the current context we very clearly need to help finance our domestic investment.

So it is a tricky tradeoff. I don't know how you would easily come out. But I must say that any form of change in legislation which endeavors to tighten up on taxes, has a consequence—significantly diverting investment to other countries. I think on our net balance we lose.

Mr. MOODY. How sensitive do you think the volume of investment is to this question of tax compliance?

Mr. GREENSPAN. I don't honestly know. I think it is the type of thing which is very difficult to gauge, but I would suspect that we might be able to get some information, looking back at our past history, when we had withholding taxes on and off and could see what kind of revenue came in. But I have not looked at those data.

Mr. MOODY. Potential revenue loss is truly significant. Less than 100-percent compliance is probably the nicest way that one could describe what is happening out there.

Since the revenue consequences would be significant, maybe it would behoove somebody to try to estimate the sensitivity either in terms of volume loss if we were to ask for withholding, or the premium increase we might have to pay to keep the volumes at the level we want.

Clearly in the capital markets there is a very close substitutability both on the demand and the supply side. It is possible that the fall-off would be relatively little.

Mr. **Greenspan**. I think one thing we would have to conclude in that process, Mr. Moody, is something which is very tricky. The issue is not investing so much in the United States as investing in dollar instruments. If you invested, if you had a choice of investing in the Eurodollar market, say, dollar obligations available in London or Tokyo or someplace else at a different tax rate, I think what we would find is that an extraordinary shift would occur in the funds which would be in the Eurodollar market as distinct from here.

While some of that comes back in as inflow of funds, not all of it does. So it is a very difficult analytical evaluation But from a public policy point, you are clearly raising a very tricky question.

Mr. **Moody**. I don't think we want to be in an official posture of not assessing or requiring legally obliged taxes so that we can increase volume. It puts us in a difficult spot to say we are going to close our eyes to tax obligations because we have to feed the deficit monster at a certain rate. Not a very nice thing to say.

Mr. **Greenspan**. No, I think it is a very difficult political dilemma.

Mr. **Moody**. But on the other hand, if the Eurodollars do come back here, and if those investors must be offered a slight premium to get the dollars under a tax-compliance regime, it might well be worth it. I would hope that someone would look at this question and try to quantify it.

Mr. **Greenspan**. My suspicion is that it is more than slight, but I can't say that I come to that impression from any deep analytical insights.

Mr. **Moody**. You would agree that we need to look at it?

Mr. **Greenspan**. I think the level of tax avoidance needs to be looked at, yes.

Mr. **Guarini**. Mr. Frenzel.

Mr. **Frenzel**. Thank you, and thank you for your testimony. I read some of it and certainly concur that our problem is of our own making. As long as we run large deficits and have a low savings rate, we are going to have to live off of imported capital.

There are a couple of ways that we can improve our situation. The easiest and first is to reduce the deficit, but somehow that has escaped Congress' agenda, or ability to cope with the problem. Yesterday we had some suggestions of bills that some Congressmen think would be helpful. One of them was to get a greater degree of disclosure and you have discussed that a bit today. Do you have enough figures to work with? Do you need any greater disclosure than is now required?

Mr. **Greenspan**. I certainly do not. In other words, for the analytical work that we have to do, the decisions that we have to make, while there are major problems in the data, in fact the bigger problems are not in direct investment in the United States, but in U.S. investment abroad where the valuation processes are really extraordinary, and we think a number of assets are missed.

But I think we have the capability of making those ad hoc adjustments in the context of balance of payment data from other parts of the world. I know of no decisions that the Federal Reserve has made or any analytical insights that we are required to make which have fallen short because of a significant lack of data on direct investment in the United States.

Mr. **Frenzel**. There was another suggestion, that we arm the U.S. Trade Representative with power to effect some sort of reciprocal restrictions, mirror restrictions, where foreigners keep us from investing in certain parts of their market. Do you have some thoughts on that?

Mr. **Greenspan**. Well, Mr. Frenzel, I have the same problem with that as I do in the trade area. One can demonstrate I think fairly generally that the fewer barriers there are to imports throughout the world the better off everybody is. When you get to this process of trade negotiation, it is a very valuable tool. If we can get other countries to lower their trade barriers that helps us, it helps them, it helps everybody else. But the other side of that coin, if they refuse, and we raise our barriers, I think neither we nor the rest of the world is helped.

If that is the type of negotiations we have to be in, then I would say there is a symmetry in that sort of problem with respect to direct investment as well as on the trade side.

Mr. **Frenzel**. Thank you.

One other question you raised just now is the question of U.S. investment abroad. We have now been told that we are in a negative relationship compared to foreign investment in the United States.

On the other hand, as I understand the Commerce Department figures, which seem to be what we are working with in this case, the U.S. investment figures are probably very greatly understated because they are cost figures that go back a long way.

For instance, our Ford and General Motors properties on the docks of Yokahama have had a very low evaluation and are worth who knows how many tens of millions of dollars. My guess is that if you marked everything up to market prices, U.S. investment abroad would be considerably greater than foreign investment in the United States.

Do you have a thought on that? I guess you get some idea of that on the return from that investment compared to what is going out.

Mr. **Greenspan**. No; I think that is correct, Mr. Frenzel. I think that you can make an adjustment one of two ways. You can either make it on the grounds that the book value of those direct investment assets abroad rise with the internal price level and the exchange rate. The internal price rate of the country in which the property is invested, plus the exchange rate, or as you suggest, as an alternate, to try to infer the market value from the data we have on the income that is derived from those investments.

In both instances it is very clear that the direct investment of U.S. business abroad, or more exactly, of American residents abroad, is probably several hundred billion too low.

Mr. **Frenzel**. Thank you very much, Mr. Chairman.

Mr. **Guarini**. Again, Mr. Chairman, our profound thanks. We are grateful to you for your testimony and your responses. We are thankful that you have shared your experiences and your thinking with us. We wish you well and look forward to seeing you again.

Chairman **Rostenkowski**. I want to thank you, too. We can always depend on your expert testimony. We appreciate the fact that you have taken time out of your busy schedule to join us. Thank you very much.

Mr. **Guarini**. The next panel of Cynthia Blum, professor of law, Rutgers School of Law, and Leonard Schneidman, Esq., Foley, Hoag, & Eliot, Boston, MA.

Will you please be seated. Your written testimony will be inserted in the record. We appreciate your coming forth and giving us your remarks.

Ms. Blum, you are welcome, we would appreciate it if you will begin.

STATEMENTS OF CYNTHIA A. BLUM, PROFESSOR OF LAW, RUTGERS SCHOOL OF LAW, NEWARK, NJ

Ms. **Blum**. Thank you, Mr. Chairman.

I apologize for my hoarse voice. In the last session the House passed a measure imposing tax on capital gains derived by foreign direct investors in U.S. companies. This represents a major change in U.S. international tax policy but was not the focus of detailed hearings.

The provision provoked harsh criticism here and abroad in the press. It was dropped in conference. In my written statement I discussed the possibility that this proposal may be revived. If this proposal is to be successful, I think some changes need to be made. I think the committee should more clearly explain its goals in this proposal, and changes should be made to make the proposal more palatable and, third, criticism of the proposal must be addressed more directly.

The committee's stated goals are to bring equality to the U.S. treatment of foreign and U.S. investors and consistency to the treatment of different ways that foreign investors can realize the benefits of their U.S. investments. As you know, U.S. investors are subject to a double tax on corporate income. They are taxed at ordinary rates on dividends or capital gains from disposing of their stock. Foreigners are taxed only on dividends. Thus taxing foreigners on their capital gains plugs a gap in the U.S. double-tax system. The committee, however, needs to make clear why this goal of consistency and equality is important.

If the objective is to ensure that foreigners pay their fair share of U.S. tax revenues, then there needs to be further discussion of the very low revenue estimates for the bill. If the objective is to avoid a competitive advantage for foreign investors, then we need clarification of the existing foreign tax treatment of foreign investors. If the objective is, as some speculate, to deter hostile takeovers, then it must be considered whether this is the best way to achieve that.

I would like to turn to some of the objections of the critics for a moment. The first is that there is a lack of international acceptance of this measure. I think the committee should reconsider its decision to override existing treaty provisions. Such an override detracts from our believability as a treaty partner and will have a negative impact on future treaty negotiations. Instead, Congress could instruct the Treasury should seek to renegotiate treaties to permit the tax and to reconsider the need for an override at a later date.

While critics point out that the majority of treaties now prohibit the tax, perhaps these treaty provisions could be renegotiated. At least in some cases the current treaty provisions were inserted at the insistence of the United States rather than the treaty partner.

This tax could be made more palatable to treaty partners by modeling it on the existing dividend tax, by agreeing to reduced treaty rates comparable to those for dividends, and by agreeing to a fresh start basis for treaty investors.

A second concern of critics is enforceability. It is important that a withholding certificate procedure to avoid overwithholding be inserted. It is also important to avoid underwithholding by raising the withholding rate. There are also other enforcement concerns that Congress must address.

Finally, many critics have said that the bill will discourage foreign investment in the United States. Others have argued that the effect will only be to increase the burden on foreign governments and not foreign investors because the new tax will be credited abroad. The committee needs to make explicit whether it believes foreign investment will be reduced, even if that is not its goal, and what the economic effect of that will be.

As one last point, critics have noted that the revenues raised by the measure are a meager $50 million in 1993, after the treaty override. It is worth exploring whether changes in the measure, such as increasing the withholding rate, could increase the revenue and whether greater revenues might be expected after 1993. But if the goal of the committee is to avoid a competitive advantage for foreign investors, then it should make clear that revenue is not a measure of its success.

Thank you, Mr. Chairman.

[The statement of Ms. Blum follows:]

Statement of Cynthia A. Blum

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I would like to address the topic of capital gains derived by foreign shareholders in U.S. companies, about which I have written.[1] Presently, the U.S. generally does not tax gains of foreign persons from dispositions of stock unless the gains are connected with the foreigner's conduct of a business in the U.S. (e.g., dealing in stock) or the stock is in a U.S. real estate holding company.

I. 1989 House Bill

The House version of the 1989 Reconciliation Act (the "1989 House bill") would have taxed capital gains derived by foreign persons from the disposition of stock in U.S. companies as if such gains were effectively connected with a U.S. business. This tax would have applied to sales by foreign corporations and individuals if the taxpayer owned more than 10% of the stock in the U.S. company (actually or by attribution). There were special rules for sales made through diversified partnerships. The tax would have been generally at the same rates applied to U.S. persons, and would have reflected, for foreign individuals, the proposed temporary capital gains preference. The tax would have been collected, at least in part, by withholding. The provision would have overriden existing, contrary provisions in treaties beginning on July 11, 1992.[2]

II. Prior Proposals

The idea of taxing capital gains derived by foreign persons from stock in U.S. companies did not originate in 1989. Senator Packwood made a similar proposal to the Finance Committee in March, 1986.[3] The House voted in the Revenue Bill of 1987 to treat the amount received in liquidation by a foreign parent from its U.S. subsidiary as a dividend to the extent of the subsidiary's earnings and profits (which would have included the subsidiary's gain from disposing of its assets in liquidation).[4] Also, one topic in the Treasury's April, 1987, outline for its study of Suchapter C was the "[a]ppropriateness" of taxing foreign shareholders on liquidating distributions and stock sales.[5]

This history suggests that this proposal is a persistent one.[6] Yet there has been little, public debate before Congress of the proposal.[7] I will begin by discussing the justifications that were offered for the 1989 House proposal and some aspects of the design of the proposed tax. Then, I will discuss the objections that were raised to the proposed tax and consider to what extent these objections can be addressed by modifying the proposal. I will point out the issues that need to be further explored with the help of revenue estimators, economists, and our treaty negotiators. Finally, I will briefly discuss the relationship between this proposal and the existing tax on gain from stock in real estate holding companies, and the relationship between this proposal and proposals for corporate integration.

III. Rationale for Proposed Tax

A. In General

The rationale for the proposal is consistency in the treatment of U.S. and foreign shareholders and in the treatment of different methods by which foreign investors can realize the benefits of their direct investments in U.S.

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[1] *See* Blum, "How the United States Should Tax Foreign Shareholders," 7 *Va.Tax Rev.* 583 (1988) [hereinafter "Blum"]; Blum, "Changing the U.S. Taxation of Foreign Shareholders," forthcoming in *Proceedings of 82d Annual Conference of N.T.A.*, held in October 1989 [hereinafter "Blum-NTA"].

[2] Proposed I.R.C. §§ 899(a),(b) and 1447; 1989 House Bill § 11404(c). *See generally* Renfroe et al., "1989 Tax Bill: Taxing Foreign Investors on Capital Gains," 44 *Tax Notes* 1415 (1989); Blum-NTA, *supra* note 1.

[3] *See* Staff of the Joint Comm. on Tax'n, Tax Reform Proposals in Connection with Committee on Finance Markup 1365-66 (Comm.Print 1986); *see also* discussion in Blum, *supra* note 1, at n.3.

[4] H.R. 3545, 100th Cong., 1st Sess. § 10139(a) (1987) (amending I.R.C. §§ 332(a), 337). *See* Blum, *supra* note 1, at n. 3.

[5] *See* Outline of Issues for the Treasury Study of Subchapter C, *reprinted in* High.& Docs. 372, 374 (April 13, 1987).

[6] *See also* Renfroe, *supra* note 2, at 1415.

[7] *See,e.g.,* NYSBA Tax Section, "Report on Certain Provisions of the Revenue Reconciliation Act of 1989," 44 *Tax Notes* 1543, 1544 (1989) (suggesting "full and deliberate airing of the implications").

companies.[8] In a domestic context, corporate income is subject to two levels of tax. When a U.S. individual invests in a U.S. company, he is taxed at ordinary rates on receipt of either a dividend or a capital gain from disposition of his stock. Although proposals to reduce the rate of capital gains taxation and for indexing were made in 1989 and will be considered again in 1990, these proposals do not call for complete exemption of capital gains.

An important principle of U.S. international taxation has been to equalize the treatment of U.S. and foreign investors in the U.S.[9] in situations where the U.S. can appropriately exercise source-based jurisdiction over foreign investors. This equality is violated by failure to tax capital gains of foreigners.[10] The results are that: (1) Foreign investors do not bear as much of the U.S. tax burden as the U.S. can legitimately expect; and (2) foreign investors in U.S. companies receive a competitive "advantag[e]" over U.S. investors, unless the home country's taxation of capital gains makes up for the lack of U.S. taxation. The Ways & Means Committee expressed concern that this might "unduly distor[t] investment markets."[11]

This argument about equality assumes that the U.S. can properly exercise source-based jurisdiction over capital gains of foreigners in U.S. companies. I submit that this jurisdiction is proper as a logical extension of the well-accepted jurisdiction over dividends paid by U.S. companies. However, as noted below, this jurisdiction over capital gains is not widely accepted.[12]

It is well accepted that the U.S. has jurisdiction to tax dividends paid by a corporation organized in the U.S. There appears to be an implicit assumption that the earnings of a U.S. corporation are generally derived from activities of a U.S. business.[13] A nondividend distribution (in a redemption or liquidation) similarly involves a corporate transfer of assets to a shareholder, and logically one would expect the same source rule to apply as to a dividend distribution.[14]

When stock is disposed of in a sale to a *third party*, there is no distribution of corporate assets. But the sale is still a way for the shareholder to realize the value of corporate earnings; the price received represents the discounted value of expected future distributions.[15]

Failure to tax foreign shareholders in U.S. companies on gains from nondividend distributions or from stock sales creates a gap in the second-level U.S. tax. In the case of a nondividend distribution to a foreign investor, assets permanently leave corporate solution without incurring any second-level U.S. tax.[16] The same may also be true in the case of a stock sale: If the buyer is a U.S. corporation, the sale proceeds leave the corporate solution of the buyer without incurring a second-level U.S. tax. In other cases, after the stock sale, a nondividend distribution can be used by the buyer to withdraw assets from the acquired corporation as a nontaxable recovery of basis.[17]

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[8] *See* Ways & Means Report on 1989 House bill, *reprinted in* High. & Docs., Supp. of Sept.21,1989, S-61 to S-62 ["House Report"].

[9] *See* *id.* at S-62.

[10] *See* ABA (Section of Taxation), "Comments on Proposed IRC §§ 899 and 1447," 18 *Tax Mgt.Int'l.J.* 467, 467 (1989) (proposal makes sense "[p]urely from the point of view of consistency of internal U.S. domestic tax policy," but "considerations of international policy and economics historically have dictated otherwise").

[11] *See* House Report, *supra* note 8, at S-61.

[12] *See* American Law Institute, *International Aspects of U.S. Income Taxation* 40-42, 93, 110-12 (1987) (gain from stock that is "passive investment" should be "sourced" by "residence").

[13] This explains the (at least partial) exemption from tax for dividends paid by an 80/20 company, for whom this assumption is incorrect. *See* I.R.C. § 871(i)(2)(B); *see also* discussion in ALI, *supra* note 12, at 62-66.

[14] *Cf.* Hay v. Comm'r, 145 F.2d 1001 (4th Cir. 1944) (treating a liquidating distribution made abroad by a U.S. company to a foreign shareholder, with a tax avoidance purpose, as a dividend from U.S. sources despite 1939 Code provisions).

[15] *See generally* R.Brealey & S.Myers, *Principles of Corporate Finance* 49-52 (1988).

[16] *See* Warren, "Recent Corporate Restructuring and the Corporate Tax System," 42 *Tax Notes* 715, 715-16 (1989) (in a "leveraged buyout" by one corporation of another's stock or a "debt-financed share repurchase," a "full ordinary income shareholder tax" is not imposed on some types of shareholders receiving distributions, such as "foreign investors").

[17] *See generally* Warren, "The Relation and Integration of Individual and Corporate Income Taxes," 94 *Harv.L.Rev.* 717,727-28(1981).

This gap in the second-level U.S. tax distorts behavior by encouraging foreign shareholders to realize the earnings of U.S. companies by means of stock dispositions (unless the home country's tax prevents capital gains from being more lightly taxed than dividends). The Ways & Means Committee suggested also that foreign investors may have a tax incentive to forego current dividends and to accumulate earnings in preparation for stock dispositions.[18] (Whether tax rules are conducive to accumulation depends, however, not only upon the U.S. and foreign tax treatment of dividends and capital gains but also upon the tax treatment of investments made inside or outside the corporation by the foreign shareholder.)[19]

B. *Treatment of Foreign Corporations*

1. *Foreign Corporate Shareholders*

In order to insure that the U.S. double-tax regime applies to foreign as well as U.S. investors, the Code generally denies foreign corporate shareholders the dividends received deduction granted to U.S. corporate shareholders. Since the U.S. is not in a position to impose its shareholder-level tax on distributions by a foreign corporate shareholder to its own foreign shareholders, the U.S. must apply the tax instead to the dividends received by the foreign corporate shareholder.[20] For the same reason, if the U.S. is to tax stock gains of foreign investors, no exemption should be granted to foreign corporate shareholders (e.g., under section 332), except perhaps on receipt of assets of a U.S. business distributed in liquidation by a subsidiary. The problem of double taxation resulting from this treatment of foreign corporate shareholders[21] needs to be addressed by treaty reductions of the U.S. tax rate, like those negotiated for dividends.

B. *Foreign Corporation with U.S. Branch*

The branch tax was enacted in 1986 to insure that the second-level of U.S. tax applicable to income of a U.S. subsidiary of a foreign parent also applies to income of a U.S. branch of a foreign corporation.[22] Once the second-level tax is extended to stock dispositions by foreign parents, the rationale for exempting branch terminations from branch tax disappears.[23]

V. *Form of Proposed Tax*

The 1989 House bill, following the pattern of FIRPTA,[24] treats a more-than-10% foreign shareholder's capital gains as effectively connected with a U.S. business; consistent with this approach, the Ways & Means committee report did not suggest treaty rate reductions comparable to those applied to dividends.[25]

Commentators have pointed out that this could create a tax bias in favor of dividends for foreign parents because the 34% corporate rate applied to capital gains would far exceed the usual 5% treaty rate for dividends.[26] (This assumes that the foreign tax treatment does not eliminate this bias.)

This potential for distortion could be avoided, and the tax perhaps made more palatable, if the tax followed more closely the simpler tax pattern applied by the U.S. to investment income, including dividends, of foreigners. Under this approach,[27] the tax is imposed at a flat rate, deductions are not allowed, the tax is collected by withholding at the same rate, and the foreigner is not required (absent other connections with the U.S.) to file a complete U.S. tax return. Most significantly, capital gains of foreigners would be accorded the same treaty rate reductions accorded dividends (generally to

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[18] House Report, *supra* note 8, at S-62; *see also* Treasury Outline, *supra* note 5, at 374 (listing as a topic relating to foreign shareholders: "[p]enalty taxes ... issue of need to prevent unwarranted accumulation of earnings if shareholder-level tax ultimately avoidable through sale of shares").

[19] *See* Blum, *supra* note 1, at 661-65 & n.120; Warren, "The Timing of Taxes, 39 *Nat'l Tax J.* 499, 510 (1986).

[20] *See* ALI, *supra* note 12, at 164 (tax viewed as "surrogate").

[21] *See* J.D.R. Adams & J. Whalley, *The Int'l Taxation of Multinational Enterprises in Developed Countries* 43, 52, 73-77, 114-124 (1977) (discussing problem with respect to dividends, both with and without corporate integration in residence country).

[22] *See* Joint Comm. on Tax'n, *General Explanation of the Tax Reform Act of 1986* 1036-37 (May 4, 1987).

[23] *See* House Report, *supra* note 8, at S-62, S-64 (regulations providing exemption for branch termination should be amended).

[24] *See* Blum-NTA, *supra* note 1; Renfroe, *supra* note 2, at 1416, 1421.

[25] *See* House Report, *supra* note 8, at S-65.

[26] *See* NYSBA, *supra* note 7, at 1555; Boidman & Gartner, "Rostenkowski's Proposals Would Affect Canadians," 18 *Tax Mgt.Int'l.J.* 395, 397 (1989).

[27] *See generally* ALI, *supra* note 12, at 10-11, 102-04.

15% for individuals and 5% for direct investments by corporations), except to the extent that this would reduce the *overall* tax burden on capital gains to a level below that applied to dividends. A similar approach is to classify the stock gains as dividends but only to the extent of earnings and profits of the U.S. company.[28]

If a capital gains preference is enacted for U.S. individuals, it could be extended to foreign shareholders simply by providing a reduced fixed rate. For example, if U.S. individuals are granted a 30% deduction, the rate for foreign shareholders' capital gains could be set at 21%. An argument could be made for extending this reduced rate to foreign corporate as well as individual shareholders.

VI. *Arguments of Critics*

A. *Lack of International Acceptance*

A large number of U.S. tax treaties deny the source country the right to tax capital gains of residents of the other country unless the gains are connected with a business in the source country or are derived from real estate there.[29] Treaties permitting the tax include those with Australia, Austria, Denmark, Ireland, Switzerland, U.K., and China.[30] Developing countries are more likely than developed countries to assert this type of jurisdiction,[31] but most foreign investment in the U.S. is from developed countries. Thus, it might be a long, difficult process to negotiate treaties to permit imposition of the tax. The U.S. would at least be required to cede to the treaty partner the right to impose a comparable tax on U.S. investors and might be required to make other concessions. Perhaps, these negotiations would be less difficult if the U.S. agreed to grant treaty investors a reduced rate and a new basis[32] from the date that the treaty provision took effect.

On the other hand, as others have argued, it is not advisable to impose the tax in violation of treaties.[33] A treaty override "undermines the basis of trust existing between" treaty partners[34] and may "invite retaliation"[35]; it may "impair Treasury's ability to negotiate tax treaties and ... damage the relatively cooperative nature of international relations with regard to tax matters."[36]

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[28] *See* "Ways & Means Press Release Announcing Continuation of Hearings on Tax Policy Aspects of Mergers and Acquisitions," *reprinted in* BNA-DER No.70 (April 13, 1989) at L-6 (listing this option).

[29] *See* House Report, *supra* note 8, at S-61.

[30] *See* Renfroe, *supra* note 2, at 1424 (listing the first six); Blum, *supra* note 1, at n. 236 (discussing U.K. and China); *see also* I.R.C. § 865(f) (contemplating imposition of such a tax by a foreign country). It is not yet clear what capital gains provisions are in new treaties with Spain or India. A draft of the Spanish treaty apparently permitted Spain to tax gains derived by U.S. holders of at least 25% of the stock in a Spanish corporation. *See* Letter from Robert D. Kennedy of Union Carbide Corp. to Treas. Sec'y, 89 TNT 156-27 (July 31, 1989).

[31] *See* United Nations Centre on Transnational Corps., *International Income Taxation and Developing Countries* (U.N. Doc. ST/CTC/56) at 51-52 (developing countries that have granted tax inducements to transnational companies should consider "impos[ing] the normally applicable income tax to liquidating sales and distributions and other disinvestment dispositions"); *see also* U.N. Guidelines and Model Income Tax Treaty (1979), Guideline 13 and Observations, *reprinted in* R.Rhoades & M.Langer, *Income Taxation of Foreign Related Transactions* § 15.06[13] at 15-275 & 276.

[32] *See* Renfroe, *supra* note 2, at 1424 (comparing provision relating to FIRPTA in Canadian treaty).

[33] *See, e.g.,* ABA, *supra* note 10, at 471 (discussing 1989 House bill); Doernberg, "Legislative Override of Income Tax Treaties: The Branch Profits Tax and Congressional Abrogation of Authority," 42 *Tax Lawyer* 173, 200-210.

[34] Memorandum From the Group of Six on Certain Treaty Override Issues, *reprinted in* High.& Docs. 559, 560 (July 21, 1987).

[35] Letter of John S. Nolan to Treasury official, *reprinted in* High.& Docs. 2794, 2795 (Sept. 15, 1989).

[36] ABA, *supra* note 10, at 471. For negative reaction from abroad to the House bill, see, e.g., Letter from Pierre Beregovoy, L'Attache Fiscal to French Embassy, to Treasury Sec'y, *reprinted in* High. & Docs. at 818 (Oct. 20, 1989); Matthews, "Capital Gains Tax on Foreigners Would be Major Change in Int'l Tax Policy," 44 *Tax Notes* 954, 964 (delay in override "not satisfactory" to treaty partners) [hereinafter "Matthews"]; Matthews, "U.S.-W.Germ. Treaty Is Ready to Sign, But House Treaty Overrides Pose Threat," 44 *Tax Notes* 489, 490 (1989).

In addition, imposing the tax without treaty renegotiation (or in the absence of a treaty) might lead to double taxation of the foreign investor. The home country might treat the gain as sourced in the home country for purposes of applying relief from double taxation. (Similarly, under U.S. foreign tax credit rules, gain from the disposition of a more-than-10% interest in a foreign company is not always recognized as being from foreign sources.[37]) Moreover, absent treaty renegotiation, a foreign tax credit may be denied by the home country because the gain is recognized under U.S. law in a different year than under foreign law.[38]

B. Difficulties of Enforcement

Some have questioned whether the proposed tax can be adequately enforced,[39] and this issue merits serious consideration.

The Ways and Means Committee concluded that a withholding mechanism was necessary to insure collection of the proposed tax and noted that withholding was already required for dividends.[40] Obviously, withholding on capital gains involves greater problems because the buyer's withholding obligation must be defined as a fixed percentage of the amount realized, even though the actual tax is based upon the amount of the seller's gain.[41] But these problems can be overcome. As under FIRPTA (but not the 1989 House bill), a foreigner should be permitted to obtain from the IRS, in advance of sale, a certificate authorizing withholding of only the maximum amount of the actual tax; alternatively, excess withholding should be refundable immediately after the sale.[42]

With these safeguards against overwithholding, it should also be possible to structure the withholding mechanism to avoid underwithholding. Contrary to the rule under FIRPTA and the 1989 House bill, the withholding rate applied in the absence of a withholding certificate should be the maximum rate at which the tax is applied, subject to treaty rate reductions. This approach is facilitated if a fixed statutory tax rate is applied to stock gains, as it is to dividends.

Withholding cannot be applied to transactions in publicly-traded stock (except perhaps transactions involving large blocks) without unacceptable disruption of stock trading. Because collection is not realistic without withholding, these transactions must also be exempted from tax. This is accomplished most simply, by limiting the tax (as under the House bill) to 10%-or-more shareholders.[43] This limitation may be justified not only on administrative grounds but also because direct investment has a stronger nexus to the U.S. than portfolio investment.[44]

Two major enforcement problems remain. The first is the difficulty of enforcing the withholding obligation against a foreign purchaser who does not conduct business in the U.S.[45] This problem can be ameliorated, but not eliminated. First, as under the 1989 House bill, any U.S. person (or a foreign person engaged in a U.S. business) through whom the sale proceeds pass (e.g., a broker-dealer) could be made the withholding agent, in lieu of the foreign buyer.[46] Second, a purchaser might be made responsible for any unsatisfied withholding obligation resulting from the acquisition of stock by his seller[47]; in this way, a foreign purchaser might often be deterred from ignoring his withholding obligation because the obligation would become a burden upon the eventual sale of his stock.

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[37] *See* I.R.C. §§ 864(a),(f),(h); 1248(a).

[38] *See* Matthews, *supra* note 36, at 955 (quoting Joseph H. Guttentag, who argued that treaty solution to this problem "is hard to work out"). For discussion of the Canadian treaty's rules on this subject, see Gann, "The Concept of an Independent Treaty Foreign Tax Credit," 38 *Tax Law Rev.* 1, 74-76 (1982).

[39] *See, e.g.,* NYSBA, *supra* note 7, at 1545 ("it will be difficult, and simply impossible in some cases, to obtain satisfactory compliance"; "measure will be routinely disregarded or avoided").

[40] *See* House Report, *supra* note 8, at S-61 to S-62; *see also* Renfroe, *supra* note 2, at 1416 (describing FIRPTA mechanism as "successful in collecting a portion of the [FIRPTA] tax ... on the date of the sale"); *id.* at 1421 (noting "differences" between withholding under FIRPTA and under the 1989 House bill).

[41] *See, e.g.,* Kaplan, "Creeping Xenophobia and the Taxation of Foreign-Owned Real Estate," 71 *Geo.L.J.* 1091, 1119-20; discussion at Blum, *supra* note 1, at 637-39.

[42] *See* Renfroe, *supra* note 2, at 1421; *see also* NYSBA, *supra* note 7, at 1557; ABA, *supra* note 10, at 469.

[43] For withholding with respect to publicly-traded stock, see Prop.I.R.C. § 1447(b)(2), discussed in Renfroe, *supra* note 2, at 1422. The Ways & Means Committee apparently believed that SEC reporting requirements applicable to more-than-10% holders of publicly-traded stock would make collection possible even absent withholding. *See* House Report, *supra* note 8, at S-61 to S-62.

[44] *See generally* Blum, *supra* note 1, at n.219 (precedent in other countries); *id*. at n.218 (direct investment often viewed less favorably than portfolio investment by host country).

[45] *See* Letter of Deloitte Haskins & Sells ("Deloitte") to Treasury official, *reprinted in* High.& Docs. 595 (Oct.17,1989) ("large blocks ... can be sold offshore without coming to [IRS] attention").

A second problem is the ability of foreign persons to legally avoid the proposed tax by holding the stock in a U.S. corporation through a foreign holding company and eventually disposing of the stock of the holding company.[48] A partial solution is to require the holding company to recognize its gain with respect to the stock in its U.S. subsidiary at the time of any liquidation of the holding company.[49] This would generally prevent avoidance of the proposed tax if the purchaser is a U.S. person because a U.S. person would probably be unwilling to retain the foreign holding company structure (e.g., because of the U.S. withholding tax on dividends paid by the U.S. subsidiary).[50]

There is no method of preventing avoidance when there is a foreign purchaser, who would probably be willing to retain the holding company.[51] Avoidance of the tax may not be permanent, however; on any eventual sale to a U.S. purchaser (regardless of the number of intervening sales), the liquidation of the holding company would trigger all gain accrued by it during its ownership of the stock in the U.S. subidiary. Moreover, even a foreign seller to a foreigner purchaser might have to bear some of the burden of the tax because the sales price would likely be discounted somewhat to reflect the potential future triggering of the tax.

There is a similar opportunity for avoidance of the branch tax proposed to be imposed on terminations. A foreign shareholder could sell the stock in a foreign corporation with a U.S. branch, rather than have the foreign corporation sell, and thus terminate, the branch. Again, the only way to discourage this technique is to impose the branch tax at the time of any liquidation of the foreign corporation. Liquidation probably could be put off, however, unless the stock was sold to a U.S. purchaser or a foreign purchaser for whom treaty protection from the branch tax was not available.

C. Effects on Investment Flows

Critics of the proposal argue that it is designed to discourage foreign direct investment in the U.S. or, that, in any event will have that effect.[52] There was also speculation that the goal was to deter foreign hostile takeovers,[53] but some argued that the effort would be ineffective.[54] The Ways & Means Committee stated, however, that it did "not intend to impose a penalty on foreign investors... or to discourage [them] from making substantial direct investments in the United States."[55] It did not discuss what impact the tax could be expected to have on investment flows into the U.S.

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[46] *See* Prop.I.R.C.§ 1447(d)(1) (withholding agent is "last United States person to have control ... of the amount realized, ... or if there is no such United States person, the person described in the regulations); House Report, *supra* note 8, at S-65; *see also* Renfroe, *supra* note 2, at 1421-22.

[47] For a somewhat similar rule under FIRPTA, see I.R.C. § 1445(c)(1),(f)(4); Treas.Reg. § 1.1445-3(c)(1),(3).

[48] *See* Renfroe, *supra* note 2, at 1419, 1424-25; *cf.* Dale, "Effectively Connected Income," 42 *Tax Law Rev.* 689, 714-15 (1987) (avoidance of § 897).

[49] *See* Proposed I.R.C. § 899(c) (nonapplicability of nonrecognition provisions apart from regulations).

[50] *See* Blum, *supra* note 1, at 651-52.

[51] *See* Renfroe, *supra* note 2, at 1419 ("it may not be necessary or desirable for a foreign" purchaser of the foreign holding company's shares "to liquidate the foreign holding company in order to get a step-up in basis in the stock of the U.S. company"); *see also* NYSBA, *supra* note 7, at 1555 ("more flexibility" to avoid tax with "foreign purchaser").

[52] *See,e.g.,* Matthews, *supra* note 36, at 954-55 (quoting Gerald T. Ball, who cited effect of Common Market unification); Letter of Nolan, *supra* note 35, at 2795 (tax "would severely reduce the attractiveness of foreign investment in [U.S.]"); Oliver, "A Sneak Attack on Foreign Investment," Op-Ed Page, N.Y.Times, Sept.21, 1989.

[53] *See* ARA, *supra* note 10, at 467, 471. Treating foreigners' stock gains as dividends to the extent of earnings and profits was one of the options presented for consideration at a Ways & Means hearing dealing with acquisitions and leveraged buyouts. Press Release, *supra* note 28.

[54] NYSBA, *supra* note 7, at 1555 (new tax "will discourage few if any foreign takeovers of American corporations").

It may be difficult for economists to predict that impact precisely. First, it is necessary to determine whether, and to what extent, imposition of the proposed tax would actually increase the *overall* tax burden on capital gains. This depends upon the rate of the proposed tax and the foreign tax treatment (including the extent to which the proposed tax is creditable[56]). Also relevant are the effective date rules of the proposed tax. Second, it is necessary to predict how and to what extent the predicted change in tax burden can be expected to affect investment decisions.[57] One consideration is how equating the tax treatment of capital gains and dividends would affect decisions regarding accumulation.[58] In addition, it has been suggested that the effect of an increase in the tax burden on repatriation is to reduce such repatriation in the short-term, but to decrease new investment in the long-term.[59] There is also the possibility that the proposed tax will alter the perception of the U.S. as being a stable environment for investment (particularly if treaties are overriden and there is no "fresh-start" provision for existing investments).[60] Assuming that the proposed tax would reduce investment flows into the U.S., the expected economic effect of that reduction needs to be analyzed. If it is clear that even minor reductions in investment flows into the U.S. have serious, negative consequences, perhaps the desirability of the existing withholding tax on dividends and the branch tax should also be open to question.[61]

A full analysis of economic effects would also take into account the responses of other countries (whether in retaliation for a treaty override or pursuant to treaty renegotiation), particularly reciprocal taxes that might be imposed on capital gains of U.S. investors.[62] The effect of reciprocal taxes would depend upon the extent to which they were creditable against U.S. taxes on the gains. This would depend upon: the rate of foreign tax, the applicability of section 1248, and the treatment of the gain if section 1248 was not applicable.[63] Crediting of the foreign tax would reduce U.S. tax revenues.[64] Any part of the foreign tax that is not creditable would increase the tax burden on U.S. multinationals; it has been argued that this would damage U.S. "competitiveness" abroad.[65]

D. *Revenue Effects*

The revenue estimates for the proposed tax in the 1989 House bill were only $50 million for 1993 (the first year after the treaty override).[66] It is

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55. House Report, *supra* note 8, at S-61 to S-62.
56. *See* ABA, *supra* note 10, at 471 ("in many cases the tax would be borne by foreign governments" because a foreign investor subject to the tax "generally would be allowed a foreign tax credit").
57. For effects of corporate tax changes, see Hartman, "Tax Policy and Foreign Direct Investment in the U.S.," 37 *Nat.Tax J.* 475 (1984); Young, "The Effects of Taxes and Rates of Return on Foreign Direct Investment in the U.S.," 41 *Nat.Tax J.* 109 (1988); Murthy, "The Effects of Taxes and Rates of Return on Foreign Direct Investment in the U.S.: Some Econometric Comments," 42 *Nat.Tax J.* 205 (1989); Young, "Reply to Murthy's Comment," 42 *Nat.Tax J.* 209 (1989). *See generally* Adams & Whalley, *supra* note 21, at 154-58 (role of tax considerations for multinational enterprises).
58 *See supra* note 19 and accompanying text.
59. *See* Roin, "The Grand Illusion: A Neutral System for the Taxation of International Transactions," 75 *Va.L.Rev.* 919, 942-45, 964-65 (1989) ("second-tier taxes" may "encourag[e] the reinvestment of earnings," while discouraging new investment).
60. *See* Matthews, *supra* note 36, at 955 (citing Ball); ABA, *supra* note 10, at 471.
61. *Cf.* Letter of J.Roger Mentz to Jt. Comm., *reprinted in* High.& Docs. 302, 303 (October 10, 1989) (citing "longstanding position of the U.S. to encourage the free flow of capital into" U.S.).
62. *See,e.g.,* Letter of Nolan, *supra* note 35, at 2795; Comments of Nat'l Foreign Trade Council ("NFTC"), *reprinted in* High.& Docs. 395, 396 (House proposal would trigger "retaliat[ion] against U.S. shareholders or even ... override [of] other treaty provisions"); NYSBA, *supra* note 7, at 1545 (predicting "harsh responses that would adversely affect United States multinationals").
63. *See supra* note 37.
64. *See,e.g.,* ABA, *supra* note 10, at 471 ("retaliatory taxes ... would be borne by the U.S. government").
65. *See* Comments of NFTC, *supra* note 62, at 395.
66. JCX-52-89, *reprinted in* Highlights & Docs. at 2986 (Sept. 21, 1989).

not clear, moreover, that this estimate takes account of revenue losses from reciprocal taxes through the foreign tax credit.[67] It has been argued that the low revenue estimates undermine any justification for the tax.[68]

There are two possible answers to this argument, which require further exploration. First, if the chief goal of the proposed tax is to achieve greater equality in the treatment of U.S. and foreign investors, the amount of revenues raised is not a measure of success.[69] Second, it is possible that greater revenues might be expected under the House proposal after 1993 or that revenues could be increased by a tightening of the proposal, e.g., by increasing the rate of withholding in the absence of a withholding certificate. To test this hypothesis, Congress needs to probe the assumptions used by the revenue estimators.[70]

VII. Tax on Gain from Stock in Real Estate Holding Company

While Congress is considering whether to tax stock gains of foreigners, it should also reconsider the existing tax on foreigners' gains from stock in U.S. real estate holding companies.

According to an ABA Task Force studying the 1989 House bill, presently foreigners "typically" hold U.S. real estate in a U.S. subsidiary of a foreign holding company and have the subsidiary dispose of the real estate and then liquidate.[71] In this way, the investor incurs an immediate corporate-level tax on the disposition but permanently avoids the second-level tax.[72]

If, however, the proposed new tax is enacted so that foreign investors in U.S. companies are generally made subject to two levels of U.S. tax, there is no apparent reason to exempt investors in real estate companies.[73] Simultaneously repealing the FIRPTA tax on stock gains[74] would bring considerable simplification since it would no longer be necessary (after treaty negotiation) to determine whether a U.S. company is a real estate holding company.

If the proposed tax is not enacted, the FIRPTA tax on stock gains still should be reconsidered. As Professor Feld has noted, its original objective of substituting for the corporate tax permanently avoidable under the General Utilities doctrine is now "obsolete."[75] He has further asked what justification now exists for denying foreigners investing in U.S. real estate the tax deferral otherwise granted to foreigners when they dispose of assets indirectly by disposing of stock ownership.[76] A possible answer is that this deferral is particularly objectionable in the case of real estate because (1) real estate has a long useful life (which allows deferral to continue indefinitely), (2) a particularly large portion of the return may take the form of price appreciation, and (3) in a domestic context, real estate is usually not held in corporate form.[77]

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[67] See, e.g., Matthews, supra note 36, at 955 (Guttentag predicts overall revenue gain would, thus, be small); Letter of Deloitte, supra note 45, at 596.

[68] See Deloitte, supra note 45, at 595; Letter of Mentz, supra note 61, at 303; Letter of Nolan, supra note 35, at 2795.

[69] See ABA, supra note 10, at 467 (proposed tax "neither intended nor expected to raise significant revenues," but to "establis[h] a `level playing-field'").

[70] If foreign investors in U.S. companies were expected to make few sales of stock in 1993, the assumed reason might have been either that (1) the tax would discourage sales, or (2) sales would have been planned to occur before the statute (or the treaty override) took effect, or (3) even apart from the tax change, foreign investors would wish to retain their holdings. In the latter two cases, foreign investors might be more inclined to sell their holdings at some future time, and thus greater revenue might eventually be realized. Revenue estimators might also have predicted that little tax would be paid on sales that did occur in 1993. They might have assumed that (1) pre-effective date sales had been made to related parties so as to achieve a stepped-up basis, (2) pre-effective date transfers had been made to foreign holding companies, the stock of which could be sold in 1993, or (3) tax would be illegally avoided, either by a foreign purchaser failing to withhold or because the required withholding would often be much less than the actual tax. With regard to the first two strategies, see Renfroe, supra note 2, at 1424-25. Some revenue loss of this type could be stemmed by barring a stepped-up basis from related party sales as under FIRPTA, see id. at 1424 n.87, by raising the rate of withholding to no less than the maximum applicable tax rate, and by imposing a foreign purchaser's unsatisfied withholding obligation on his eventual purchaser.

[71] See ABA, supra note 10, at 468.

[72] See I.R.C. § 897(c)(1)(B).

[73] But cf. ABA, supra note 10, at 468 (noting "adverse impact" on real estate "tax planning").

[74] But cf. Proposed I.R.C. § 899(e)(1) (providing for coordination of FIRPTA tax with proposed new tax).

[75] See Feld, "Is FIRPTA (Partially) Obsolete?," 35 Tax Notes 607-08 (1987); see also Dale, supra note 48, at 714 ("repeal of General Utilities" makes FIRPTA's "utility ... dubious").

Even if this answer should prove convincing, one might question how much the FIRPTA tax on stock gains actually accomplishes. If one assumes, as suggested above, that under current law foreign investors in U.S. real estate do not achieve deferral of the U.S. corporate tax, one must consider whether this result would change with repeal of the FIRPTA tax. Repeal would give foreign investors the option of deferring the U.S. corporate tax (while still avoiding shareholder-level tax) by selling stock in a U.S. real estate holding company, which the buyer agrees to keep alive. Perhaps, however, this is not an acceptable option to a U.S. buyer. Moreover, if the buyer is foreign, there already exists[78] the option of selling stock in the foreign parent company without liquidation.[79] Alternatively, some foreign investors in U.S. real estate may currently hold it directly in a foreign company.[80] (This may not be attractive unless there is treaty protection from the branch tax and no desire for "home-country anonymity.")[81] This option (whether it culminates in sale of stock or sale of the real estate followed by liquidation) is unaffected by repeal of the FIRPTA tax on stock gains.

The foregoing argument about FIRPTA's effectiveness, combined with the administrative difficulties of enforcement (particularly, determination of a U.S. company's status as a real estate holding company), and with doubts regarding the theoretical justification for the tax, seems to make a convincing case for repeal. A possible countervailing consideration is the fact that, in many of its treaties, the U.S. has now successfully claimed the right for itself and its treaty partner to impose such a tax and may find it difficult to reverse this treaty position.

VIII. Integration of Corporate and Shareholder Taxes

The rationale for imposing a tax on stock gains of foreign shareholders in U.S. companies is to reinforce the double tax system applied by the U.S. to corporate income. The question arises whether such a tax would be appropriate if Congress were to integrate the shareholder and corporate taxes. Under the integration plans most often considered in the U.S., the corporate tax would be eliminated or reduced for distributed earnings by way of a dividends-paid deduction or a shareholder credit. This dividend relief might or might not be extended to foreign shareholders.[82]

For example, under the proposal made by the Treasury in 1985, a corporation would be permitted a deduction for 10% of dividends distributed (but not nondividend distributions), up to the amount of its earnings that had been subject to corporate tax. This corporate deduction would be permitted even for distributions to foreign shareholders; but such shareholders would incur (subject to some treaty limitations) a compensatory withholding tax on dividends received, on top of the ordinary withholding tax, that is designed to recapture the corporate deduction.[83]

This integration plan was viewed as a means of reducing for U.S. shareholders the burden of the corporate tax, but not of the shareholder-level tax (which remained entirely unchanged). The goal of the plan as it applied to foreign shareholders was simply to maintain both levels of tax as is. One might argue that adoption of this plan requires the continued exemption of stock gains of foreign shareholders to prevent the tax burden on foreign shareholders from being intolerable. But perhaps a more logical approach would be first to seek to equate the shareholder-level treatment of foreign and U.S. shareholders, by taxing foreigners' stock gains, and then reconsidering whether, and to what extent, it is appropriate to deny foreign shareholders relief from the corporate tax granted to U.S. shareholders. The argument for taxing stock gains of foreign shareholders under such a plan would be more compelling if a dividends-paid deduction were available for nondividend distributions as under the Treasury's 1984 proposal.[84] In that case, a stock sale by a foreign shareholder to a U.S. shareholder followed by a nondividend distribution would eliminate both levels of tax (absent a tax on stock gains).

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[76] Feld, *supra* note 75, at 608; *see also* Kaplan, *supra* note 41, at 1122-23 (asking why foreigners' gains are taxed only if derived from real estate).

[77] *See* Blum, *supra* note 1, at 670-71.

[78] *See* Dale, *supra* note 48, at 714-15 (arguing that FIRPTA stock tax should be repealed since "well-advised" foreigners already avoid it by "hold[ing] U.S. real estate in foreign corporate solution, and ... dispos[ing] of it by selling the stock").

[79] *See* Blum, *supra* note 1, at 671-74.

[80] *See supra* note 78.

[81] *See* Hudson, "Post-1988 Tax Planning for Foreign Direct Investment in the United States," 18 *Tax Mgt.Int'l.J.* 3, 5-10 (1989).

[82] *See e.g.* Joint Comm. on Tax'n, *Tax Reform Proposals: Corporate Taxation* (JCS-40-85), September 19, 1985, *reprinted in* BNA Daily Tax Rep. No. 185 (September 24, 1985) at J-1, J-3 to J-5, J-7 to J-10.

[83] *See* JCS-40-85, *supra* note 82, at J-3 to J-5, J-9.

Instead of following the Treasury's 1985 proposal, Congress might choose an integration plan that extends relief from corporate tax to earnings distributed to foreign shareholders. Adoption of such a plan would, if anything, strengthen the case for requiring foreign shareholders to bear a tax on gains from stock dispositions. If foreign shareholders are granted the benefits of equal treatment with respect to the corporate tax, the argument for imposing the detriment of equal treatment under the shareholder-level tax is more compelling.

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84. See Treasury Dept., 2 Tax Reform for Fairness, Simplicity and Economic Growth 137-38 (1984).

Mr. **Guarini**. Mr. Schneidman, we welcome you.

STATEMENT OF LEONARD SCHNEIDMAN, FOLEY, HOAG & ELIOT, BOSTON, MA

Mr. **Schneidman**. Mr. Chairman, members of the committee, first, I would like to thank you as a tax lawyer for the opportunity to testify this morning before the committee of the House which initiates all our tax laws. Chairman Greenspan has discussed with great knowledge the global context of international investment and more particularly foreign investment in the United States.

I am somewhat humbled by the fact that I am here to talk about one proposed section of the Internal Revenue Code, but one which I feel could have a much wider international implication than it might first appear.

The proposal to which I speak is section 899 of the code which imposes a tax on sale gains to foreigners owning more than 10 percent of the stock of a U.S. corporation. This proposal appears to have been motivated by a narrow congressional concern; namely, to inhibit foreign led LBO acquisitions of U.S. companies, but its potential effects are far more far-reaching.

I describe in greater detail in my written testimony the international tax norms against which this proposal must be judged and focus on a number of assumedly unintended consequences of the proposal, as contained in the House bill. What I would like to do this morning in my brief time before you is to highlight some of these considerations.

Historically, the United States has never taxed foreigners on their capital again income unrelated to a trade or business in the United States. Generally, under international tax norms, the sale of stock should be taxed only by the country of the seller's residence, not the country where the corporation is incorporated. This principle has been embodied in U.S. domestic tax laws since their inception.

It is part of the domestic tax laws of most of our major trading partners, and it is reflected in numerous tax treaties, including the U.S. model income tax treaty, the OECD model income tax treaty, and existing U.S. income tax treaties with various countries.

Unilaterally overriding a principle of such long standing and wide acceptance undoubtedly would be unwise from an international tax policy point of view. It would be unwise for the following reasons, among others.

It might lead to a significant diminution in the amount of foreign investment in the United States. Already signs of such a slowdown are beginning to appear. For example, the Wall Street Journal on January 16, 1990, featured an article entitled, "Yankie Stocks Feel Chill from Overseas," describing the lack of present enthusiasm of foreign money managers for making equity investments in the U.S. stock markets.

Second, it might lead to retaliatory legislation by foreign governments, resulting in taxation of U.S. investors by foreign countries which does not exist today. In addition, it could upset the heretofore cooperative relationship between sovereigns that has existed in the international tax field. And finally, the legislation as proposed would open a Pandora's box of consequences, both to the apparently intended foreign investors, as well as to foreign investors clearly never intended to be affected.

For example, it could affect portfolio as distinguished from direct investors, including the investment by foreigners in U.S. mutual funds. It could significantly impede foreign venture capital investment in the United States. The unintended interaction of this proposed Code section with other provisions of the Code could affect areas as far afield as foreign investment in U.S. real estate, a topic covered specifically by another code section.

To illustrate at least one anomalous result, assuming a foreign partner with an 11-percent partnership interest in a partnership which owns 11 percent in a U.S. corporation. The foreign investor could end up being subject to the 899 tax, although his true economic interest in the U.S. company is only 1.2 percent.

This is just one of a number of anomalous results created by 899 as proposed in the House bill. It is not within my purview to enter into the current debate regarding advantages and disadvantages of leveraged buyouts and foreign takeovers of U.S. businesses.

My point is simply that section 899 is an inappropriate vehicle to attempt to influence this very important issue, and I strongly urge that it not be enacted by Congress and certainly not in the form proposed. Thank you.

[The statement of Mr. Schneidman follows:]

STATEMENT OF
LEONARD SCHNEIDMAN
BEFORE THE HOUSE COMMITTEE
ON WAYS AND MEANS

at Washington
January 25, 1990

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss certain tax policy issues with respect to foreign investment in the United States. In my testimony, I will focus on recent proposals to tax foreigners when they sell stock of U.S. corporations. In particular, I will discuss proposed sections 899 and 1447 of the Internal Revenue Code, which were passed by the House last fall as part of the Revenue Reconciliation Act of 1989. While these proposed sections were ultimately dropped from the Conference Committee bill signed by the President, I understand that the sentiments that prompted the House to pass the proposal remain strong in some quarters, and I am pleased to have the opportunity to comment on the proposal.

I understand that this proposal was intended to remove a perceived advantage of a foreign direct investor owning stock in a U.S. corporation, by establishing a "level playing-field" with regard to the U.S. tax imposed when the investor ultimately sells his interest in the company. And in fact, the Congressional motive may well have been even more narrow--that is, to inhibit a foreign-investor-led hostile "LBO" acquisition of a U.S. company. In the form passed by the House, however, the proposal would appear to have potentially broad and far-reaching effects on our international tax policy and on foreign investment in the United States.

First, the proposal represents a radical change in a long-standing and widely-held principle of international taxation and involves serious issues of unilateral "overrides" of existing treaties. Second, while the proposal is intended to tax foreigners who are engaged in hostile takeovers of U.S. companies, the proposal may have far more wide-ranging and complex effects on foreign investment in the United States. Third, the proposal's interaction with other provisions of U.S. tax laws appears to affect even the targeted foreign investors in complex and possibly unintended ways, and to affect other foreign investors at whom the proposal was not directed.

The balance of this statement first briefly summarizes current U.S. tax law applicable with respect to foreign investment in U.S. corporations and then describes the recent proposal and my reasons for believing that Congress should not enact such a tax upon sales of stock in U.S. corporations by foreigners.

1. CURRENT LAW.

The United States federal income tax consequences relating to income derived by foreign taxpayers from investment activities in the United States varies, depending upon the source of the income and whether such income is effectively connected with a United States trade or business, if any, conducted by the foreign taxpayer. Generally, foreign taxpayers are subject to United States tax on income effectively connected with the conduct of a trade or business in the United States, regardless of the source of the income, and with respect to all other kinds of income, subject to tax only on United States source income.

For example, the United States generally does not tax nonresident alien individuals and foreign corporations on the capital gains they realize when they sell stock of a U.S.

corporation.[1] This principle has been embodied in the United States tax laws since their inception, and follows long-standing and widely-adhered-to international practice. With regard to interest and dividend income, a foreign taxpayer not engaged in a trade or business in the United States is taxable only on interest and dividends from United States sources. Generally, interest income earned on obligations of U.S. residents is U.S. source income.[2] Likewise, dividend income generally will be U.S. source income if it is paid with respect to stock held in a domestic corporation.

To the extent any United States source income not effectively connected with a United States trade or business is taxable to a non-resident alien or foreign corporation, such tax is imposed at a statutory rate of 30 percent or a lower treaty rate, if applicable, and the payor of such income is required to withhold tax at that rate upon payment to the foreign person.

Foreign investors often utilize some form of offshore structure, including entities organized in foreign jurisdictions other than the investor's home country, in making their United States investments. In addition to offshore structures, United States investment planning may also involve the utilization of certain domestic vehicles. Thus, for example, foreign venture capital investments in the United States may be made through United States partnerships.

2. THE PROPOSED LEGISLATION.

On October 5, 1989, the House passed its version of the Revenue Reconciliation Act of 1989. Section 11404 of this House bill would have added new sections 899 and 1447 to the Internal Revenue Code. Proposed section 899 would have taxed non-resident alien individuals and foreign corporations when they sell stock of any U.S. corporation in which they hold more than a 10-percent stake; proposed section 1447 would have required withholding agents to collect the tax.

The statutory language of proposed sections 899 and 1447 was extraordinarily complex. In general, disposition of any amount of stock in a U.S. corporation would attract the new tax if the non-resident alien individual or foreign corporation shareholder held more than 10 percent (by vote or value) of the corporation's stock at any time during the five years preceding the disposition. The proposal contained numerous ownership attribution rules, which would cause certain persons to be considered as owning more than 10 percent of a U.S. corporation's stock, no matter how little stock they owned directly. The tax would have been effective generally for dispositions of stock occurring more than six months after enactment. Beginning on July 11, 1992, the proposed tax would have overridden the provisions of U.S. tax treaties, unless those treaties were renegotiated before that date.

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[1] The United States does, however, tax these gains if they are effectively connected with the seller's conduct of a trade of business within the United States. The United States tax law has historically made a distinction between investment activities and engaging in a trade or business, so that individual investors typically are not so engaged. In addition, since the enactment of the Foreign Investors Real Property Tax Act of 1980 ("FIRPTA"), foreign-owned United States real estate interests have been subjected to a separate taxing regime. The major thrust of that Act was, in contrast to the treatment of other gains, to tax foreign taxpayers on gains realized on their dispositions of interests in United States real property, including stock of United States corporations whose assets are composed substantially (i.e., more than 50 percent) of United States real estate.

[2] The taxability of interest income to foreign taxpayers is subject to a number of important specific exemptions, including: (1) interest paid with regard to deposits with U.S. persons carrying on a banking business; (2) certain portfolio interest; (3) interest paid by a U.S. state or municipality; and (4) original issue discount on obligations with a term to maturity of 183 days or less.

The Treasury Department strongly opposed the measure as violative of the non-discrimination articles in U.S. tax treaties. The proposed tax also elicited serious concern in the foreign financial press and from the governments of our major trading partners. Even though the tax was merely a proposal, it already appears to have begun to discourage foreign investment. For example, because the proposal contained no exemption for overseas pension funds, at least one major fund suspended further venture capital investment in the U.S.[3]

After the House passed the proposed tax last fall, I chaired a Task Force of the Committee on U.S. Activities of Foreigners and Tax Treaties of the American Bar Association's Section of Taxation. Our Task Force submitted comments to the Joint Committee on Taxation and a recommendation that Congress should not enact proposed sections 899 and 1447.

The following section describes some tax-policy considerations raised by this proposal, and the final section of my comments then gives examples of the proposal's complex and, in some cases, possibly unintended results.[4]

3. TAX POLICY CONSIDERATIONS.

The recent proposal to tax foreigners when they sell stock of U.S. corporations represented a rejection of a long-standing and widely-held tenet of international taxation: that a sale of stock generally should be taxed only by the country of the seller's residence, not the country where the corporation is organized. This principle has been embodied in U.S. domestic tax laws since their inception; it is part of the domestic tax laws of most of our major trading partners;[5] and it is reflected in numerous tax treaties, including the U.S. Model Income Tax Treaty, the OECD Model Income Tax Treaty and existing U.S. income tax treaties with various countries.

Congress in effect reaffirmed and broadened this principle in the Foreign Investors' Tax Act of 1966 (the "1 66 Act"), on the recommendation of a task force appointed in 1963 by President Kennedy to study foreign investment in the United States. In the Tax Reform Act of 1986, Congress undertook a serious reconsideration of the Internal Revenue Code's foreign tax provisions, and left in place the rules reflecting long-standing international tax policy, including the principle that capital gains generally should be taxed only by the country of residence, not the country of source. In fact, the 1986 enactment of the branch profits tax shows that Congress recognized the continuing validity of the principle. Moreover, the recent Federal Income Tax Project of the American Law Institute recommended continuing adherence to this principle.[6]

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[3] Letter of Milton A. Levenfeld and Michael J. Tuchman to Treasury, on behalf of British Telecommunications Staff Superannuation Scheme, a pension fund that provides retirement benefits to former employees of British Telecom, excerpted at Tax Notes 547 (October 30, 1989).

[4] For a complete technical discussion of these issues, see the American Bar Association Task Force Report, described above.

[5] A few countries tax certain nonresident-alien and foreign-corporation shareholders on sales of stock in domestic corporations, but even in those cases the tax usually is abrogated by treaty in the case of U.S. shareholders (e.g., Austria, Canada, France, and West Germany). In contrast, the tax proposed by the House last fall would have overridden contrary treaty provisions.

Unilaterally overriding a principle of such long standing and wide acceptance undoubtedly would be unwise from an international tax policy point of view. The American Law Institute's 1986 proposals stated three reasons for adopting internationally-acceptable United States tax laws: first, an international consensus may indicate the correct economic, theoretical or political result; second, the United States needs the cooperation of other countries on important international tax matters, such as negotiating treaties, requesting information and obtaining help in enforcing U.S. tax laws, and resolving double-tax cases; finally, inconsistency of international tax laws leads to gaps and overlaps in tax coverage, producing undesirable distortions of economic behavior. Proposed section 899 raised all of these concerns.

The express treaty override proposed for section 899, in particular, would be certain to impair Treasury's ability to negotiate tax treaties, and to damage the relatively cooperative nature of international relations with regard to tax matters. The proposed three-year grace period during which the House expected Treasury to renegotiate existing treaties would have been unlikely to mitigate these adverse foreign-relations aspects of a unilateral treaty override. Moreover, the language implementing the grace period raised questions as to whether a particular treaty is a "comprehensive income tax treaty" and otherwise made it difficult to determine whether an investor would be entitled to the grace period.

Practically, the enactment of this proposal would have two effects on international taxation. First, in many cases the tax would be borne by foreign governments, not their subjects. Second, the proposal may initiate retaliatory legislation, the economic burden of which would be borne by the U.S. Treasury, not by taxpayers. A foreigner who paid the new U.S. tax often may be allowed a foreign tax credit against his taxes in his home country. Accordingly, that country would collect less tax, while the United States collected more. In these cases, the proposal is not a tax on the affected foreign shareholders, but a tax on their governments. Because of this, those governments are likely to retaliate with similar, reciprocal taxes on Americans who own stock in foreign companies. For example, the U.K. government opposed the "earnings-stripping" provision[7] of the recently-enacted U.S. tax legislation, and currently is considering a similar measure of its own. Those retaliatory taxes, too, would be borne in many cases by the U.S. government, and not by the affected U.S. shareholders in the foreign companies, because of the U.S. foreign tax credit. Because by some measures the United States still may be a net exporter of capital,[8] the U.S. fisc would be the loser in this reciprocal tax regime, because it would forgo more taxes (in the form of the foreign tax credit) than it collected as a result of proposed section 899.

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[6] Proposals on United States Taxation of Foreign Persons and of the Foreign Income of United States Persons, May 14, 1986.

[7] Section 7210 of the Revenue Reconciliation Act of 1989 (H.R. 3299), enacting new subsection 163(j) of the Internal Revenue Code.

[8] Because U.S. investments overseas and foreign investments in the United States generally are recorded at book value, and because many U.S. investments overseas were purchased earlier than many foreign investments in the United States, the value relationship of net investments is somewhat controversial. At any rate, until it can be demonstrated that the United States' net investment position has changed for a substantial period of time, such a change should not be relied upon as an impetus for changing U.S. tax policy regarding foreign investment.

The effective dates of the proposal were especially troubling. In general, the affected foreign investors would have been taxed on their sales of stock in U.S. companies beginning six months after enactment, regardless of when they acquired the stock. These investments were based on existing U.S. law: the investors reasonably expected not to be subject to U.S. income tax when they disposed of their investments. Since U.S. law followed the basic international norm, their expectation was well-founded. Taxing these investors on prior investments would appear to be unfair.

The proposal's actual effects on foreign investment in the United States are unclear and, in any event, I am not a professional economist. Nonetheless, from my direct professional experiences advising foreign investors about U.S. taxes, several effects seem likely. First, because of the difficulty inherent in drafting a provision narrow enough to affect only the targeted investors, the proposed tax undoubtedly would affect many other types of investors, who may be the very types of investors that U.S. tax laws should promote rather than discourage.

Second, because the proposal was so complex, it likely would deter many investors to whom it did not apply, simply because they were unsure whether the proposal applied to them. The 1963 Presidential Task Force noted that complex tax laws are themselves a deterrent to foreign investment.[9]

Third, the retroactive nature of the proposed tax certainly would discourage many more investors to whom the tax did not apply, because they fear that Congress may enact retroactively an adverse change in U.S. tax law that will affect their U.S. investments.

4. EXAMPLES.

The following section gives several non-exhaustive examples of the proposal's complexities and possibly unintended effects.

(a) Portfolio Investments.[10]

Even though the proposed tax was aimed expressly at "direct" investments by foreign investors, the proposal may adversely affect portfolio investors as well.[11]

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[9]
> [T]he actual fiscal impact of this or any other tax law on the persons to whom it applies does not measure the extent to which the law deters or limits potential investment by persons who are unwilling or unable to master its complexities. This is especially true when dealing with foreigners, whose familiarity with U.S. laws and practices is limited. Even those foreigners with substantial funds available for investment often find it troublesome and expensive to obtain sound U.S. tax advice, with the result that they channel their investments elsewhere.

Report of the U.S. Task Force on Promoting Increased Foreign Investment (in United States Corporate Securities) and Increased Foreign Financing (for United States Corporations Operating Abroad), 1964, at 25.

[10] For an extensive treatment of the taxation of U.S. portfolio investments by foreign taxpayers, see L. Schneidman, U.S. Portfolio Investments by Foreign Taxpayers, CCH Tax Transactions Library (1989).

Offshore Investment Funds ("OIFs") and other foreign corporations are a very popular vehicle for foreign portfolio investment in the United States. Most of these vehicles, including the U.K. investment trust, are treated as corporations for U.S. income tax purposes. Accordingly, if such an OIF holds more than 10 percent of a U.S. corporation, the OIF would be subject to the proposed tax when it disposes of any of that stock. Moreover, the ownership attribution rules may treat an OIF as owning stock held by related OIFs. In these cases, the OIF would be treated as holding enough stock to trigger the tax, even though its direct holdings were substantially below the 10 percent threshold.

For example, if OIF "A" owned 5 percent of the stock of a U.S. corporation, and OIF "B" owned 10 percent or more in value of OIF A's stock, then OIF A would be treated as owning OIF B's stock in the U.S. corporation. If OIFs A and B together held more than 10 percent of the U.S. corporation's stock, then OIF A would be subject to tax under section 899 when it disposed of any of that stock.

Furthermore, if a mutual fund (either foreign or domestic) owned more than 10 percent of the stock of a U.S. company, then under certain circumstances each of the fund's foreign shareholders may also be regarded as owning more than 10 percent of that company's stock. This application of the proposal's ownership attribution rules would cause each foreign shareholder of the fund to be subject to the new U.S. tax whenever the fund disposed of any stock in the company, no matter how small the shareholder's pro rata interest in the fund. It is unclear whether any of the proposed partnership exceptions to the attribution rules contained in section 899, as proposed (described below), would be available to mutual fund shareholders. Also, the proposed ownership attribution rules would require a foreign investor to account for stock in U.S. companies owned through mutual funds, as well as directly, in determining whether the 10 percent ownership threshold had been met during the 5 years preceding a sale of stock. Investors would find it difficult to obtain this information under current mutual-fund reporting procedures. Application of the proposed tax to mutual fund stockholders almost certainly would discourage foreign investment in these funds.

The House bill also provided that Treasury may issue regulations "aggregating stock held by a group of persons acting together." Under this provision, each member of such a group may have been subject to the new tax if the group held more than 10 percent of a U.S. company's stock. For example, the tax may have applied to a group of unrelated foreign investors who invested through the same broker or advisor. If the broker or advisor made a "buy" recommendation for the stock of a U.S. corporation and, as a result, the foreign investors placed orders such that together they held more than 10 percent of the corporation's stock, any one of the investors might have been subject to the proposed tax if he disposed of the stock within 5 years.

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[11] Portfolio, as used herein, denotes passive investments, where the investor exercises no control over the issuer or obligor of the investment. Direct investment, on the other hand, is an investment where the investor influences or controls the investment, for example, the acquisition of a United States business through the purchase of a controlling stock interest. The usual line of demarcation for a direct investment is 10 percent of voting power or voting securities. See, for example, Section 127 of the Tax Reform Act of 1984 repealing withholding on portfolio interest, and the provisions of the International and Trade in Services Survey Act (22 USC §3102(10)), requiring Department of Commerce reporting in the event of foreign direct investments in the United States.

(b) Investments by Partnerships.

According to the proposal, if a partnership owned more than 10 percent of the stock of a U.S. company, and non-resident alien individuals or foreign corporations held more than 10 percent of the capital or profits interests in the partnership, then each partner would be treated as owning more than 10 percent of the stock of the U.S. company. For example, a foreign individual may invest in a U.S. venture-capital partnership to the extent that he holds an 11 percent interest in the capital or profits of the partnership. Then, the partnership may provide venture capital to a U.S. start-up company by purchasing 11 percent of the company's stock. Even though the foreign investor's share of the U.S. company's stock would be 1.2 percent (11 percent of 11 percent), the House bill would have treated him as an 11 percent shareholder of the company. Therefore, whenever the partnership sold any of the company's stock, the foreign partner would be subject to the proposed tax.

The House bill contained two exceptions to this general partnership attribution rule. The foreign venture-capital investor in the preceding paragraph, however, generally would have been eligible for these exceptions only if the U.S. company's stock constituted less than 25 percent of the partnership's assets. If the partnership had been an investment partnership formed to invest in U.S. public securities, eligibility for the exception would have been especially difficult. For example, the House bill contained no exception for the partnership's start-up and wind-down periods. Accordingly, when the newly-formed investment partnership made its first investment in a U.S. company, the company's stock would constitute more than 25 percent of the partnership's assets, causing the foreign investment partner to be subject to the proposed tax whenever the partnership disposed of any of the stock. This would have been the case even though, after a start-up investment period during which the partnership made its other planned investments, the company's stock constituted only a very small percentage of the partnership's assets. Under the House bill, in effect, the partnership could have qualified for the exception only by making its first 5 portfolio investments simultaneously, and by disposing of its last 5 investments simultaneously.

The partnership's eligibility for the exception also would have been complicated by the House bill's requirement that the partnership use fair market value to test whether a U.S. company's stock constituted 25 percent of the partnership's assets. Market fluctuations would require the partnership to monitor its compliance continuously, and a momentary period of volatility could cause the partnership to fail the qualification requirement.

These uncertainties likely would cause excessive withholding (because general partners are personally liable for under-withholding) and would create a substantial disincentive for foreign investors to acquire interests in partnerships that invest in U.S. public companies.

If the partnership determined that it clearly qualified for the exception, each partner would be treated as owning only his aliquot share of the U.S. corporation's stock. Even then, however, the foreign investor may find it difficult to determine whether he is liable for the proposed tax when the partnership disposes of the stock, and the general partner will have difficulty in determining whether to withhold on a distribution of the stock-sale proceeds to the foreign investor, as follows:

Because the partnership qualified for the exception, the foreign investor would be treated as owning only his aliquot share, or 1.2 percent, of the partnership's stock in the U.S. company. In order to comply with the proposed tax and withholding rules, the investor, the partnership and any prospective buyer would be required to ascertain whether the investor was a 10-percent shareholder of the corporation. In making that determination, each other mutual fund or other investment vehicle in which the investor had an interest would be required to determine whether it had owned any stock, options or convertible debt of the domestic corporation at any time during the preceding 5 years, and to notify the investor. Mutual funds and other investment vehicles generally do not make such detailed reports available to investors, and the House bill would have imposed no penalty for failure to do so.

The foreign partner may know that his mutual fund has held some stock in the same U.S. company in which his venture capital partnership has invested. Mutual fund reporting procedures, however, make it unlikely that he will obtain accurate information about the scope of the fund's shareholdings. Accordingly, the investor may face a dilemma. Since he is unsure about the exact scope of his direct and indirect holdings of the domestic corporation's stock, he may hesitate to sign the required affidavit that he has not been a 10-percent shareholder. If he does not provide the affidavit, the partnership must withhold on its distribution to him of the proceeds of its sale of any stock in the corporation.

If, on the other hand, the investor signs the affidavit by relying on the best information available to him, and turns out to be wrong, he would be subject to the "zero-basis" penalty. That is, he would be liable for the proposed tax on the entire amount of the sale proceeds, not just on his gain. If there were no gain, this penalty would not be imposed, and no tax would attach. However, if the investor's basis in his stock were $100,000 and the sales proceeds were $100,001, the proposed tax would attach to the $1 gain, but the zero-basis penalty would make the investor liable for the tax on the entire $100,001 of proceeds, not just his $1 gain.

These and a number of other anomalies and presumably unintended results lead this commentator to conclude that proposed sections 899 and 1447 should not be enacted by Congress, but that if enacted, should be substantially revised to deal with these issues.

Mr. GUARINI. Thank you very much, Mr. Schneidman. I ask anyone on the committee who wishes to ask any questions, please raise your hand.

Are there any questions by any members of the committee? I just want to ask one question, Mr. Schneidman. Do I understand that you said that you do not think that it would be appropriate for us to tax sale on stock that belongs to an American corporation if it is offshore where the transaction took place, and as long as the transaction took place in a foreign country on that chattel, the stock certificate, there should be no tax. Is that what you say?

Mr. SCHNEIDMAN. No; I assume you are referring to the retaliatory legislation. This legislation could induce foreign governments to tax that sale gain, which they presently don't do.

Mr. GUARINI. OK. Thank you very much. We wish to thank the panel for their insights, and we appreciate your being here. Thank you.

Mr. SCHNEIDMAN. Thank you.

Mr. GUARINI. I would like to call to the front Julian C. Morris, president of the Automotive Parts and Accessories Association; Susan W. Liebeler of Irell & Manella, former chairman of the ITC; the International Union, United Automobile, Aerospace & Agricultural Implement Workers of America represented by their economist, Steve Beckman; and Samuel M. Rosenblatt, Association for International Investment.

Gentlemen, we thank you for being here. I know you all have written statements. They will be incorporated into the record fully. We would ask you if you could make your remarks based upon your testimony that will be incorporated into the record.

We will begin with Julian C. Morris, president of the Automotive Parts & Accessories Association. Welcome, sir.

STATEMENT OF JULIAN C. MORRIS, PRESIDENT, AUTOMOTIVE PARTS & ACCESSORIES ASSOCIATION, INC.

Mr. MORRIS. Thank you, Mr. Chairman, for this opportunity. In its discussion of the Nation's transport needs, a 1979 Government report concluded that its auto parts industry had to be "cultivated and strengthened as the foundation of the auto industry as a whole."

The Government which recognized the importance of a strong auto parts industry in this case was Japan's, and its touted industrial policy has proved highly successful. Indeed, the tight knit auto maker/supplier "family" bonds forged during Japan's postwar targeting, and the closed auto parts procurement and distribution systems that APAA long has fought to open, are being replicated here in the United States.

The MITI-orchestrated relocation of this Japanese automotive juggernaut and its impact on U.S.-car production is dislocating many competitive U.S. original equipment and replacement parts suppliers.

I will focus on the U.S. investments of a Japanese auto making/supplier industry structure, that in the words of USTR's 1989 trade report, precludes "nonfamily" suppliers from "original equipment and replacement parts markets for Japanese vehicles."

While that conclusion should trigger an alarming call to action, the United States has not yet struck a plan to save U.S. ownership of the parts making foundation of our auto industry.

We believe the structure of Japan's automotive industry long has excluded U.S. firms from equipping Japanese cars that dominate world markets. Car company headed industrial/financial groupings intertwine Japanese carmakers and suppliers so tightly that their parts makers are likened by one Japanese newspaper as "faithful servants of a feudal warrior chief." These keiritsus, as the Japanese call them, are the foremost structural impediment we know of in United States-Japan parts trade.

Japan's closed parts distribution web has joined the closed parts buying system in the United States. It remains difficult for America's independent aftermarket retailers and service outlets to provide a full line of replacement parts to owners of Japanese nameplate vehicles.

Tightly controlled Japanese parts suppliers generally restrict replacement parts sales to the car dealer network only. And, since United States and other independent parts makers often lack the economies of scale that original equipment sales provide, tool up costs for production of many replacement parts can be prohibitive.

Although the 1980's were punctuated by three key U.S. initiatives to crack these keiritsu-created barriers, United States-Japan auto parts trade figures, attached to my testimony, signal failure of increasing proportion.

The decade began with a torrent of Japanese direct and captive imports that continue today, but the parts trade gap swelled to a $9 billion gulf largely in response to surging Japanese auto making investment here.

These transplants use American labor to assemble vehicles largely designed in Japan and made from imported parts. Already vulnerable, our industry now faces its gravest threat, and possible permanent preclusion, as a third wave consisting of hundreds of foreign parts producers moves on shore to serve the transplants and compete for domestic nameplate markets.

These part plants, like their car company customers, continue to import capital goods and subcomponents for their operations here, adding further to a sea of red ink on our trade balance sheet.

GAO told Senator Bentsen last June that transplant assemblers' heavy reliance on Japanese-based supplier families for more than 60 percent of components used in assembling vehicles for sale here had cost some 23,000 net U.S. supplier jobs in 1988.

The losses came because these heavily foreign sourced vehicles largely displaced vehicle production by U.S. carmakers who use nearly 90-percent domestic sourcing ratios. Those stunning supplier jobs losses will soar this year as transplant capacity doubles and eats increasingly into domestic output.

Japanese auto/parts-making investment in the United States is a heavy factor in the continuing deterioration of our balance of payments account. Indeed, a Japanese takeover of the American automotive industry would move billions of dollars of U.S. industry profits into foreign hands while the control of much of America's industrial base, wealth, R&D, and jobs moves to foreign lands.

Keiritsu's impact on foreign investment in Japan is captured in T. Boone Picken's celebrated fight to gain a seat on Koito's board of directors.

He observes that Koito, which happens to be a Toyota lighting supplier, has not allowed him to exercise his ownership rights, because they wish to hide family business, namely the "cartel-like system that runs Japan and keeps out any foreign competition."

We believe the structural impediments initiative [SII] has set the agenda firmly toward Keiritsu reform. This new initiative also has potential to redirect the post-MOSS talks to tackle the goals of automotive industry structural changes, goals that heretofore have eluded the MOSS process.

The SII, the post-MOSS talks and the Trade Act's new 5-year Japan parts market initiative should buttress one another, adding strength to our appeal to the Japanese Government for dismantling what this committee in the Trade Act calls unacceptable Japanese barriers to U.S. original equipment and aftermarket sales.

Just briefly, let me highlight a key recommendation to help drive these negotiating vehicles. Since private, not government barriers are at issue, it is important to define successful outcomes and set timetables.

I should emphasize that our association does not desire closed U.S. markets. Rather, we believe the answer to our problems rests in opening Japanese procurement systems to accord American firms and workers the same fair commercial consideration that Japanese firms receive here.

Thank you.

[The statement of Mr. Morris follows:]

STATEMENT OF JULIAN C. MORRIS, PRESIDENT AUTOMOTIVE PARTS & ACCESSORIES ASSOCIATION, INC.

Mr. Chairman and Members of the Committee:

As the representative of more than 2,000 American producers and sellers of original equipment (OE) and replacement, or aftermarket, parts the Automotive Parts & Accessories Association (APAA) welcomes this chance to discuss the profound impact of foreign investment on America's independent auto parts industry.

With U.S. exports slowing and no breakthrough on our budget deficit-fueled desire for more imports, we applaud the Chairman for devoting serious thought and energy to developing sound U.S. trade and ivestment policy for the 1990's. The contrast between current U.S. automotive trade policy and the policies of our trading partners is acute and troubling: Our policies tend to be passive or absent, while theirs tend to be aggressive and targeted.

Nowhere is this truer than regards Japanese automotive industry policy and the unique, closed auto making/parts making family structure that has evolved under that policy. On many occasions over the past decade, APAA has come before this Committee and others in our long quest for greater openness in the Japanese parts buying and distribution systems.

The openness of the U.S. market has enabled strong sales and profits for the auto and parts making industries of Japan, Canada, Europe, Korea and many others. It is time our trading partners are told in volume and tone that cannot be ignored that the price of continued openness is evidence of reciprocal trade and investment access for U.S. suppliers in their markets.

Given the fact that Japanese auto/parts making investment in the U.S. appears to be increasing, rather than decreasing that half of our bilateral trade deficit -- and one-third of our global deficit -- represented by Japanese automotive products trade, my remarks will focus on the transplantation of Japanese business systems to the U.S. Indeed, the figures in Appendix A show a dramatic nine-fold swelling of the parts trade imbalance over the course of a decade long effort by industry, government and APAA to open parts markets wherever Japanese cars are built and sold.

In the Structural Impediments Initiative (SII), APAA believes U.S. negotiators have a strong vehicle for seeking the reform of Japanese automotive industry structural barriers that heretofore have eluded the auto parts Market Oriented, Sector Selective (MOSS) talks and other specific reform attempts of the 1980's. Moreover, APAA believes the SII has the potential to be the final negotiating word on Japanese structural reforms because it is an important adjunct to the Super 301 market opening process.

APAA and the Aftermarket We Serve

APAA members make and sell the entire spectrum of automotive parts, accessories, tools, equipment, chemicals and supplies. APAA's 1,000 U.S.-based manufacturing members represent a very significant share of the universe of 2,000 firms cited by USDOC as being engaged primarily or solely in automotive parts and accessories production for both OE and aftermarket consumption.

Thus, when I speak of APAA as industry's representative, the term refers to this vast number of firms. It does not imply that APAA speaks for every firm in the industry universe nor that APAA is the only group representing the large, diverse U.S. parts industry.

My statement will address Japanese automotive industry parts sourcing and distribution barriers and the transplanting of these closed systems to the U.S.; probe Japanese investment's effect on U.S. economic growth, employment and national interests; discuss the impact of Canadian, EC and other trade partners' investment distorting practices on U.S. parts makers; and review APAA backed policy initiatives and proposals for results-oriented talks to address trade and investment distorting practices.

Impact of Japanese Structural Impediments

Foreign car makers who can secure a significant share of the rich, open U.S. market while protecting their home market from import competition, always enjoy the upper hand in economies of scale and gain a global competitive advantage. For over 10 years and three Administrations, America's auto parts industry has warned that this is the case with the Japanese.

The structure of Japan's automotive industry long has excluded U.S. firms from equipping Japanese nameplate cars that dominate the world market.

The 1989 National Trade Estimate Report on Foreign Trade Barriers (NTE), the U.S. Trade Representative's latest report to Congress on the costliest barriers to U.S. sales, says of Japan:

> A prerequisite for selling most functional auto parts to Japanese vehicle makers is to become part of their supplier "family." "Nonfamily" suppliers are precluded from both the original equipment and replacement (aftermarket) auto parts markets for Japanese vehicles. The United States is trying to persuade Japanese vehicle manufacturers to increase their purchases of competitive, high-quality U.S. auto parts. (Emphasis added)

The International Trade Commission's December 1987 report, Global Competitiveness: The U.S. Automotive Parts Industry, (USITC Publication 2037), excerpted in Appendix B, provides an extensive discussion of the various Japanese industrial groupings, or keiritsus, each of which includes an auto producer, bank, related parts makers, and other financial and industrial operations.

The fact that keiritsus interweave companies "through equity exchanges, interlocking directorates, intra-group financial commitments, joint R&D efforts, and membership to exclusive management councils or clubs" has the reported, well-known effect of making it "difficult for potential outside suppliers (domestic or foreign) to sell to companies in the group." Japanese structural barriers figured prominently in U.S. parts makers' responses to the USITC's 1987 global competitiveness report as shown in the attached table (Appendix C).

The foremost structural impediment APAA knows of in U.S.-Japan parts trade, keiritsus tie Japanese OEM's and suppliers so tightly that a leading Japanese newspaper, the Nihon Keizai Shimbun, portrays Japanese suppliers as "vertically integrated Japanese parts companies." They further are likened to "faithful servants of a feudal warrior chief."

Japanese Automotive Investment Imports Parts Procurement Barriers

APAA consistently has warned of the threat of market erosion for American made original equipment and aftermarket sales. Japanese auto/parts inroads in the U.S. through (1) direct and captive imports bearing little U.S.-made content, (2) transplant assembly using largely Japanese content and (3) greater Japanese-controlled parts in Big Three production could give Japanese auto/parts makers the potential to control between 40% and 50% of the content of all cars sold in America in the 1990's.

Already vulnerable, our industry now faces its gravest threat and the prospect of permanent preclusion from the transplant assembly market as hundreds of Japanese suppliers move on shore. Moving here originally to keep tight ties with Japanese car makers, these companies have set their sights on selling to Big Three customers, and to cracking the lucrative U.S. aftermarket.

Indeed, in testimony cited by the USITC, former Commerce Assistant Secretary H.P. Goldfield linked Japanese structural barriers to their U.S. investment behavior. Japanese family-like auto maker/supplier relationships not only pose the primary barrier to U.S. auto parts sales to Japanese OEM's, but by their importation here, Goldfield stated, also "have effectively precluded many U.S. suppliers from participating in this huge, fast-growing" transplant market.

Currency Revaluation Hastened Investment, Widened Trade Gap

The falling dollar should have sharpened the competitive edge of

American companies seeking transplant and export sales, thereby improving our parts trade deficit by boosting exports and trimming imports.

However, as Appendix A shows, U.S. exports showed no appreciable gain, and in many cases the lower dollar turned against us by casting the U.S. as an investment bargain for the Japanese. Japanese car companies pass over attractively priced quality U.S. parts for parts from related Japanese supplier plants set up here. And these parts plants, like their car company customers, continue to import capital goods and subcomponents for their assembly operations and thereby contribute to the U.S. trade deficit. Indeed, as noted above, Japanese automotive investment in the U.S. appears to be increasing, rather than trimming, the trade deficit.

Closed Parts Distribution Web Imported

Japan's closed parts distribution web has joined the closed parts buying system in the U.S. It is getting harder for America's independent aftermarket retailers and service outlets to provide replacement parts to owners of Japanese nameplate cars. Tightly controlled OE producers generally restrict replacement parts sales to the car dealer network only. And, since most U.S. and other independent parts makers do not have the economies of scale that OE sales provide, tool up costs for purely replacement parts production can be prohibitive.

Investment's Negative Effect on Growth and Jobs

The General Accounting Office's (GAO) June 1989 report to Senator Bentsen, Appendix D, reveals staggering American job losses in the wake of Japanese vehicle assembly investment in the U.S.

GAO estimated for 1988 that only 25%, or about 200,000 of 800,000 transplant units, displaced imports. By 1990 we fear that well over 75% of the transplants' 1.6 million unit capacity will displace high U.S. sourced vehicles, adding to millions of Japanese made imports bearing little if any U.S. parts.

The report effectively challenges transplant assemblers' claims that their new U.S. production largely displaces vehicle imports. A similar challenge was raised by bipartisan leaders of the Senate and Senate Finance Committee in their July 1987 letter to Prime Minister Nakasone, attached as Appendix E. The Senators noted that the U.S. "assumed that as Japanese companies increased their automobile production capacity in the U.S., exports from Japan would decline in some corresponding way." Rather, they contend "total automotive exports are continuing to increase at a rapid pace."

Notwithstanding transplant assemblers' claims of U.S. job creation, GAO indicates a 1988 net loss of 25,000 U.S. automotive jobs (2,000 in vehicle assembly/23,000 supplier jobs). The losses are attributed to the fact that transplants' vehicle production using less than 40% domestic sourcing ratios significantly displaced vehicle production by U.S. car makers who use nearly 90% domestic sourcing ratios.

We fear those staggering losses will double this year as 1988 transplant capacity doubles and eats increasingly into domestic car output.

APAA also cautions that the job destruction related to Japanese automotive investment here is understated by the GAO numbers. For one, the data is based on plants with longer track records and not on the newer plants. To further qualify the 38% weighted average domestic sourcing ratio, APAA urges consideration of the fact that this number does not net out the heavy percentage of imported subparts, components and materials used by transplanted suppliers in assembling components and systems for transplant vehicle assembly customers.

Transplant production has added to the import market inroads of Japanese car and parts suppliers. Japanese parts firms and their workers already busily sourcing export vehicles have scored significant sales gains in the additional parts orders placed by Japanese transplants.

Just to hold their own, American suppliers need -- but have little access -- to every dollar of transplant business to offset declining domestic output. Consider the Commerce department's 1988 forecasts which "indicate that the traditional domestic manufacturers could lose some two million units of vehicle sales and 150,000 to 175,000 jobs between 1986 and the early 1990's," as they close plants to cut excess capacity. Even worse, Commerce adds that the job loss figure may be conservative "in view of the decrease in the degree of vertical integration in the industry, plus intensified competition in parts and supplier industries."

U.S. and Japanese Perspectives on Domestic Sourcing

American frustration with the poor domestic sourcing record of transplants was summed up by the Senate leadership letter, Appendix E. They contended that transplant assemblers in 1985 and 1986 had assembled 240,000 and 460,000 passenger vehicles respectively using "knock down kits with virtually all components made in Japan."

An example of Japanese transplant sourcing behavior is cited in a Salomon Brothers report, "Made in Japan" - Japanese Foreign Direct Investment and Export Prospects. If the vehicle output of transplant investment -- using 74% plus Japanese value added -- permits the Japanese OEM to expand its total U.S. sales, the analyst finds it "likely that the exports of parts and completed vehicles will rise as a result." Moreover, on the basis of all Japanese direct automotive investment, and direct investment by other Japanese sectors studied, the report concludes that in all cases "the combined exports of parts and finished goods increased."

A Japanese industry perspective on transplant sourcing and its reference to transplant sourcing of Japanese vehicle knockdown kits is provided by the Journal of Japanese Trade & Industry, Appendix F. For Japanese FY 1988, which concluded last March, it projected that "exports of motor vehicle knockdown kits for overseas assembly will likely post a growth of close to 30% in tune with increasing vehicle production in the U.S. by Japanese automakers." (Emphasis added.)

In addition, a 1988 Japan Economic Institute essay, entitled "Offshore Production: Boon or Bane for the Japanese Economy?" reports that Japanese transplant operations do "final assembly, putting together components or subassemblies mainly imported from Japan." (Emphasis added)

Supplier Migration Endangers U.S. Economy

Moves by Japanese OEM's to encourage relocation of their supplier families to the U.S. could further decimate American parts sales. Bringing closely related Japanese parts manufacturers to America is not a market opening gesture. Independent studies show, and Japan's car manufacturers know, that there are highly competitive U.S. manufacturers in every automotive product category. The capacity to supply parts already exists in the U.S. It is not necessary for the Japanese vehicle assembly plants in the U.S. to build a base of Japanese owned parts suppliers as well. Indeed, Japanese OEM's should show good faith by averting this migration and turning to existing American sources. This should be the corollary to our top objective of OE market access.

We believe Japan's frontal assault on our industry will prove disastrous for America's economy.

Japanese takeover of the Amercan automotive industry also would come at the cost of further deterioration in our balance of payments account with Japan. Billions of dollars of U.S. industry profits would move to foreign hands, while the control of much of America's industrial base, wealth, R&D and jobs would move to foreign lands.

And the losses to the U.S. are not limited to the automobile industry. Here is what lays ahead for other major American industries; Japanese bankers will finance the new plants and Japanese construction firms will build them; Japanese capital goods will equip them; and they will rely on Japanese raw materials. Japanese investment, like trade, means keeping the money in the family.

In conclusion, APAA fears that a foreign takeover of U.S. manufacturing capability of the magnitude we describe could strip the reins of U.S. trade and economic policy decisionmaking. For example, such transfer of control could loosen our grip on the potent U.S. market closing retaliatory lever, which we believe to be the principal negotiating tool for gaining reciprocal market access and investment status abroad.

Fiscal Concerns

The negative economic impact of Japanese automotive investment discussed above is exacerbated in its detrimental consequences for the U.S. Treasury. The closed Japanese investment practices take a tremendous toll on our nation's fiscal condition: (1) sharply reducing corporate tax receipts from displaced U.S. parts makers, (2) massive loss of supplier employees' income tax payments, (3) increased transfer payments for unemployed workers, and (4) the displacement of a tax paying supplier base by firms unlikely to produce taxable income for many years.

These net negative effects are magnified throughout the communites affected by dislocated firms and workers and in municipalities and states that also suffer reduced revenues.

To make matters worse, the Foreign Trade Zones Board has effectively unilaterally reduced all original equipment parts tariffs from a 4% to 11% range down to the 2.5% tariff rate applied to finished cars. The Japanese transplant assemblers are the heaviest importers and thus reap the preponderance of an estimated $100 million in total tariff concessions made last year. These Treasury-financed savings help each transplant car maker sustain the tight family links that exclude our firms' sales. In effect, by adding more black ink to their bottom lines, the current FTZ program operation is pushing America's budget and trade deficits further into the red.

APAA urged FTZ program reform in October 24, 1989 testimony before this Committee's Trade Subcommittee (Appendix G).

U.S. Policy Building

Although the 1980's have been punctuated by three key U.S. government initiatives to crack keiritsu created barriers, U.S.-Japan auto parts trade figures (Appendix A) signal failure of increasing proportion.

While APAA vigorously supports the 1989 NTE's call for continued, intensified bilateral negotiations aimed at increased sales, we believe the 1989 language should have incorporated the following strong statement which the USTR made in the 1987 NTE: The "United States is trying to persuade Japanese manufacturers to give fair consideration to competitive, high-quality U.S.-made parts." (Emphasis added.)

APAA sees the statements as complementary, in that it should not be difficult to get Japanese OEM's to increase their purchases of U.S. parts once our industry firms get fair consideration.

With Japanese cars taking increasing shares here and globally, American trade leaders should take very serious note of the USTR's 1989 NTE finding that Japan's automotive industry structure "precludes," or rules out in advance the use of U.S. OE and aftermarket suppliers.

Gaining a fairer shake at supplying the Japanese car building and aftermarket service parts markets in the U.S., Japan, and third markets was supposed to be the overriding goal of the U.S.-Japan

Market Oriented, Sector Selective (MOSS) talks that concluded in August 1987.

Today, over two years after the concluding MOSS round, little U.S. sales progress is evidenced in significantly cracking Japanese parts markets for high value-added components and systems. MOSS failed in its primary goals of reforming Japanese sourcing practices in large part because of the control the U.S. allowed Japan to exert over the agenda itself.

Sidestepping America's primary MOSS objectives, Japan cherrypicked lesser items such as trade promotion and sales monitoring from our negotiators' list of objectives. Five of seven negotiating sessions were mired down by the issue of how Japan would self-monitor post-MOSS progress. Rather than crafting a system that measures the genuine successes of traditionally excluded U.S. firms, the agreement our government endorsed allowed Japan credit for purchasing from their transplanted traditional suppliers now locating in the U.S.

This means our government effectively is rewarding Japanese OEM's for keeping the same tight bonds that the negotiations were intended to loosen.

The fact that the Administration's prescribed regimen as stated in the 1989 NTE offers two post-MOSS tonics which hardly fit the malady diagnosed -- Japanese self-monitoring of U.S. parts purchases and greater Japanese government assistance with trade promotion events -- indicates continued Japanese control of the parts trade agenda. As subsidiary goals they can support but never substitute for the primary goals of reforming Japanese parts sourcing practices.

Trade Partners' Trade and Investment Distorting Practices

My discussion of other nations' treatment of foreign investment begins with Japan. The impact of Japanese keiritsus on foreign investment in Japan is captured in Mr. T. Boone Pickens' celebrated fight to gain a seat on Koito's board. He has observed that Koito, a Toyota lighting supplier, has not allowed him to exercise his ownership rights, because he believes they wish to hide their "family" business, namely the "cartel-like system that runs Japan and keeps out any foreign competition."

Other corners of the globe impose trade related investment measures (TRIM's) and trade policies largely detrimental to U.S. suppliers and workers. To demonstrate the scope of other nations' policies, I have attached as Appendix H, USDOC's Compilation of Foreign Automotive Barriers, which appeared in the USTR's 1989 NTE.

Industrial powers and emerging nations alike have a common commitment to protecting their auto/parts making industries -- be it the Mexican Auto Decree, Brazilian content rules, Korean targeting, to name but a few -- or the Canadian Auto Pact and EC car import quotas discussed below.

Canada

APAA believes a signal has been sent to other nations by Canada's FTA-sanctioned policies. We chiefly are concerned by two trade and investment distorting policies that attract foreign owned parts makers to invest there:

1) Qualification as a Canadian-made part gives a discriminatory edge, because Auto Pact tariff savings are tied to Canadian parts purchases.
2) Similar duty remission benefits granted to Japanese and Korean transplants are contingent on use of Canadian-made parts.

U.S. based parts companies are at a decided disadvantage, as supplier migrants lock up long term sourcing agreements.

In the face of the storm of North American excess capacity -- a

2.7 million vehicle glut is projected for the U.S. this year -- Canada has built a temporary storm wall. Using assembly and CVA rules, investment subsidies and duty-free OE access to the U.S., Canada has attracted foreign auto/parts making investment and created short term safe harbors for Canadian workers. The effect is to redirect the full brunt of the waves of foreign made cars and parts at the unprotected U.S. market.

By assisting the closed Japanese sytem's relocation to North America, Canadian policy fosters a North American anomaly -- while transplanted Japanese parts makers are positioned to take enormous advantage of their duty-free access to America's open procurement system, their Japanese car maker customers remain aloof to fair commercial consideration of U.S.-made products.

EC Quotas

Maintaining a strong trade bargaining position through the requisite market levers is paramount to the European Community (EC). EC proposals to replace a host of separate barriers with one so-called "transitional" quota, holding Japanese vehicle imports below 10% market share, would give the EC the potential clout to strike a side deal with Japan. For example, the EC might trade greater Japanese import penetration in Europe for European car and parts access in Japan. Local content laws and strict rules of origin also are expected to restrict the EC market and protect its indigenous industries.

General Motors-Europe President Robert Eaton has estimated that Japanese penetration could rise to as much 30% in the post-1992 era. Given EC quotas, however, the U.S. is the only market of sufficient size and openness to mop up the available Japanese export output. Moreover, the U.S. is the only market large enough and stable enough to meet Japanese expansion plans.

This is an important point, because unlike the U.S., strict local content rules in Europe will not allow transplant sourcing behavior that relies on what Japanese industry analysts themselves call knock-down kits.

Nor would the second avenue pursued by Japanese OEM's in the U.S. -- the replication of their related supplier industry in satellite formation around their transplant facilities -- be a live option in Europe. European governments are not foolish enough to build a new supplier base next to a capable, underused, existing base.

EC auto policies once again underscore the fact that when other auto/parts producing nations can not build trade among themselves, there is but one bridge, and that leads into the vast, open U.S. market.

U.S./Japan Recommendations

APAA believes the SII talks have set the agenda firmly towards keiritsu reform. This new initiative also has tremendous potential to both reinvigorate the remaining years of the post-MOSS bilateral talks, and to redirect those negotiations to tackle the goals of automotive industry structural changes, goals that heretofore have eluded the MOSS process.

In addition to the SII and post-MOSS talks, the 1988 trade act's Quayle Amendment mandates a five-year, MOSS like Japanese parts market opening initiative. These three initiatives should buttress one another, adding strength to our appeal to the Japanese government for dismantling what the trade act calls unacceptable Japanese barriers to U.S. OE and aftermarket sales.

APAA has high expectations for SII and related reform efforts, because they stand on the Super 301 foundation, which the 1988 trade act architects built as a no-nonsense, results-oriented approach towards correcting trade abuses. To help drive these negotiating vehicles APAA urges:

(1) Since private, not government, barriers are at issue, it is vital to define successful outcomes. The 1980 bilateral parts trade approach should be revived, including an update of Japan's 1980 parts purchase target and the establishment of timetables.

(2) Send Japan a strong signal by having Commerce follow the semiconductor industry precedent for monitoring progress, and collect voluntarily submitted data on U.S. capital-affiliated firms' sales to Japanese parts markets. Similar Commerce monitoring of U.S. firms' sales was key to the 1980 effort.

(3) As part of the development of U.S. "shadow monitoring" of post-MOSS progress, bolster America's own capabilities for both compiling and using industry sales data.

For example, the development of a format for use of Census Bureau data on auto making foreign trade subzones could reveal changes in the ratio of foreign/domestic parts entering those plants. Improved collection and use of import/export data also should yield information on changes in Japanese buying behavior.

(4) Continue joint trade development efforts with stringent, bilateral follow-up monitoring of related sales progress.

(5) Remind Japan that the potent new Riegle/Levin amendment of Section 301 now holds foreign governments accountable for the lack of fair commercial consideration of U.S. products.

U.S./Canada Trade Recommendations

With vehicle overcapacity now threatening to close more North American plants, APAA fears Canada's Auto Pact rules -- especially the requirement that Pact members assemble at least one vehicle in Canada for each vehicle sold there -- could keep Canadian assembly plants open while America's heavily U.S.-sourced plants close. Indeed, as recently as 1980 two OEM's failed to meet the safeguards, and rather than pay duties on their imports into Canada undertook additional investments there. One auto maker experienced similar problems during 1973-75, and had to add truck production.

Key FTA implementing legislation provisions require swift action.

(1) A fresh approach is needed concerning what to do about multilateral sourcing and the Canadian trade and investment distorting strings attached to this enormous benefit.

(2) Progress in removing Canadian Auto Pact and production-based duty remission trade obstacles is essential if our nations are to achieve a key FTA objective -- the removal of similar performance requirements and other barriers thwarting North American automotive product exports.

(3) The U.S. should initiate a joint approach to results-oriented market access talks with Japan to help overcome Japanese automotive industry structural barriers that heretofore have excluded traditional U.S. and Canadian parts makers.

The U.S. can emphasize the potential its Structural Impediments Initiative offers for reforming Japanese automotive parts procurement and distribution systems to the benefit of competitive parts firms in the U.S., Canada and elsewhere.

(4) A North American effort, including both federal governments, the states and provinces, is needed to curb counterproductive foreign investment subsidies. The expansion of Japanese vehicle and parts production into North America at a time when the new car market is flat results in a shrinking of U.S. firms' shares.

(5) The accelerated elimination of Canadian FTA tariffs on U.S. OE shipments to non-Auto Pact assemblers, now set for a ten-year phaseout, would improve market access for U.S.-based suppliers.

(6) Negotiations to boost the rule of origin from 50% to 60%, taken in tandem with investment and trade reforms, should secure greater FTA benefits for traditional North American suppliers.

Investment Policy Recommendations

The U.S. must move promptly to develop a uniform policy on the urgent issue of Japanese and other foreign-owned supplier investment in the U.S. We have noted the fact that other nations follow a fortress model -- absorbing few imports yet expecting the U.S. to soak up their finished car/parts exports.

APAA believes that a totally benign U.S. policy, blind to the arrival of foreign-owned parts procurement systems closed to the U.S., threatens to undermine our manufacturing base, economy and security. We can begin at home by taking steps to stop unilateral concessions to foreign parts imports and investment.

(1) Reform of the Foreign Trade Zone automotive subzone program is needed to end multi-million U.S. tariff concessions that now help each transplant OEM sustain the tight family links that exclude our sales.

(2) The U.S. should gain reciprocal market access first, and only then move on to issues of reciprocal investment perks.

(3) Legislation may be needed to bar state use of federal grants to assist foreign investment that dislocates U.S. production. A similar ban already applies to interstate dislocations.

(4) The U.S. should encourage state use of funds to promote the export sales and global competitiveness of state suppliers.

(5) Better foreign automotive invesment data could be achieved by requiring 4-digit SIC reports that would distinquish between auto making and parts making enterprises.

(6) Administration consolidation of foreign investment reporting and analysis is needed to give the U.S. sound policy footing.

(7) The Trade Policy Review Group should seek Cabinet approval for the institution of an interagency study that would consider among other issues: current/projected capacity utilization for American OEM and supplier firms; the effects of adding transplant capacity (by SIC code) to existing capacity and the impact on U.S. firms' sales, profits and workers; economic consequences for the nation and states; demand projections for output of domestic OEM and supplier plants; and the role of the states in attracting the investment use of federal program funds in state investment packages, and the resultant competitive advantages inuring to foreign owned suppliers.

General Parts Trade and Investment Policy Recommendations

APAA believes that the greatest hope of parts market opening success rests in a redoubled commitment by the U.S. and other nations to strengthen the General Agreement on Tariffs and Trade (GATT) in the current Uruguay Round.

(1) Focus on a successful GATT Round, especially a TRIM accord, as the vehicle to establish a set of trade and investment rules for all member players.

(2) Firm, frequent bilateral talks also are crucial. Agendas should include substantial currency revaluation, import liberalization, stimulation of domestic demand in both consumer spending and investment, movement away from "everything for export" thinking, and export subsidy reduction.

(3) These bilateral labors, especially our new Section 301 no-nonsense negotiating approach, must yield significant results before the U.S. pursues news FTA's.

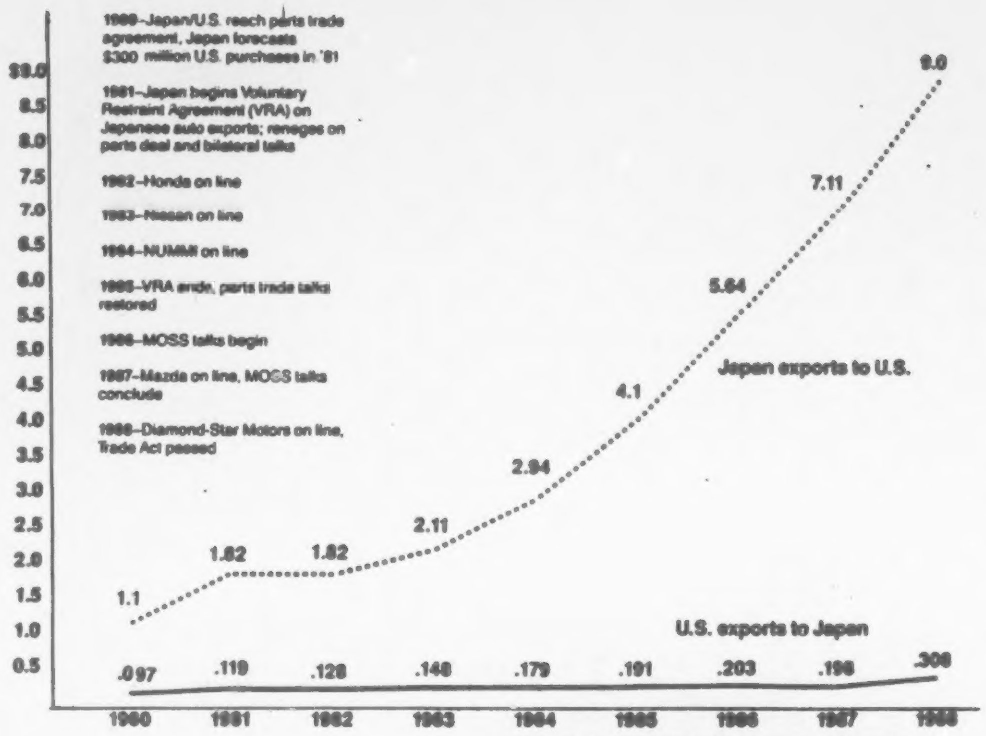
(4) As discussed in our Japan recommendations, trade development campaigns such as Export Now Korea, should include stringent bilateral follow-up monitoring of related sales progress.

Conclusion

Our trade partners have intertwined their economic security with the development of strong auto and parts making industries. APAA stands ready to work with this Committee, other Members of Congress and the Administration to build a policy that meets the trade, investment and security needs of our industry and nation.

APPENDIX A

U.S. JAPAN AUTO PARTS TRADE
$ Billions



Notes: 1984-87 imports include FTZ imports. 1988 imports include APAA's estimated FTZ imports.

We will now hear from Mr. Steve Beckman, economist for the UAW. We welcome you, sir.

If you have an opportunity to place your statements in the record, you can make remarks from there.

Thank you.

STATEMENT OF STEVE BECKMAN, INTERNATIONAL ECONOMIST, INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE & AGRICULTURAL IMPLEMENT WORKERS OF AMERICA [UAW]

Mr. **Beckman**. Thank you very much, Mr. Chairman.

My name is Steve Beckman. I am an international economist for the UAW. I want to thank you for providing this opportunity for the UAW to present its views to the committee on the important issue of foreign investment.

Mr. **Guarini**. Come a little closer to the microphone, please.

Mr. **Beckman**. The massive expansion of foreign investment in the U.S. economy during the 1980's has set off alarm bells across the Nation. The United States was the world's largest creditor country a few years ago; yet now, our foreign debt to the rest of the world is five times that of Brazil, the next largest debtor country.

The ability of the Nation and its Government to set economic policy to serve the interests of Americans rather than foreigners has been called into question.

The reason for the explosion of foreign investment in the United States is the trade deficit. Through trade and economic policies, the Reagan administration, and now the Bush administration, promoted an international exchange that paid for the large increase in U.S. imports of goods and services with U.S. exports plus hundreds of billions of dollars worth of U.S. assets—stocks, bonds, real estate and businesses—sold to foreigners.

The foreign money that has flowed into the United States to buy assets has financed the purchase of imports that have kept production and employment high in the same countries supplying the money. The interest, dividends and profits generated by foreign-owned investments will not all be spent in the United States; their use will be determined by economic conditions in the home countries of the assetholders as much as by conditions in the United States

Similarly, the decisions regarding the assets themselves—whether to reinvest, sell out or revise investment strategy—will also be made with the interest of the foreign owners foremost.

I might add the recent fluctuation in interest rates and the stock market have been attributable to concerns regarding where the countries with larger surpluses are likely to invest their money.

A powerful and influential alliance consisting of foreign firms and governments and U.S.-based multinational corporations has organized to convince the American people that, far from being a threat, foreign investment represents a vote of confidence in, and commitment to, the strength of the U.S. economy.

They want the U.S. Government to maintain the encouragement of foreign investment adopted by the Reagan administration. Legions of high-priced lobbyists, including many former Government officials and Members of Congress, have been enlisted to promote this position. In their view, all new investment in the United States is positive because too little of domestic resources are being allocated to investment and too much to consumption.

For American workers, though, the true test of the impact of foreign investment is whether it contributes to creating a U.S. economy that has full employment, a strong and diversified industrial base and jobs that provide high and rising compensation. We know from the outset that the huge U.S. trade deficits that have given foreigners the dollars to make the investments have weakened U.S. production and eliminated jobs that pay well.

The UAW has firsthand experience with the impact of foreign investment because of the large-scale foreign investment in auto and auto parts production, mostly by Japanese firms. In this industry, new capacity is being built by foreign investors even though excess production capacity already exists.

The new plants, with new work forces, lower health and pension costs and with the help of State and local Government subsidies, have already displaced thousands of UAW members and other workers with years of experience in the industry, and have the potential to displace many thousands more.

The UAW has documented the job loss that will take place as the new plants, which import a high proportion of parts and materials, continue to replace traditional U.S. production rather than builtup imports.

A modest legislative proposal by Representative John Bryant to require sizable foreign investors to register with the Federal Government and provide basic information on their U.S. and home country organization and finances has become one focus of the discussion of the effect of foreign investment on the U.S. economy. Even though other developed nations already impose such requirements, this proposal has been attacked by promoters of foreign investment in the United States.

The UAW strongly believes that it is time for the United States to assert control over its economic future and the opportunities available for its citizens. Foreign investment will be a part of that future, but it must be managed to serve the needs of American workers, not the profits of global corporations.

To achieve this objective, the United States must: eliminate its trade deficit as quickly as possible and end the exchange of assets for imports that the trade imbalance has encouraged; join other nations in collecting adequate information from foreign investors so that the promises of promoters of foreign investment are replaced by realistic analysis of the impact of foreign investment as the basis for economic decisionmaking; develop strategies that spur U.S.-industrial development—major investment decisions, foreign and domestic, should be recognized by these strategies to ensure they promote the public interest; end subsidies given to foreign investors, especially those provided by State and local governments, that reduce costs for new investors competing with existing domestic firms; and we must assure that government policies reflect the U.S. public interest.

The ability of government officials to dramatically raise their income by putting their public service experience to work for foreign countries and firms undermines the U.S. public's confidence that the economic interests of Americans are being defended by their own government.

Mr. Chairman, thank you very much.

Mr. GUARINI. Thank you, Mr. Beckman.

[The statement of Mr. Beckman follows:]

STATEMENT OF
STEVE BECKMAN, INTERNATIONAL ECONOMIST
INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE & AGRICULTURAL IMPLEMENT WORKERS OF AMERICA (UAW)
before the
COMMITTEE ON WAYS AND MEANS
on
FOREIGN INVESTMENT IN THE UNITED STATES
and
EUROPE 1992

Mr. Chairman, my name is Steve Beckman and I am an international economist for the UAW. As you are aware from previous appearances by representatives of the union before this Committee, during the 1980's, the UAW's primary concern in the international arena has been the U.S. trade deficit. Six consecutive years of record merchandise trade deficits through 1987 resulted in a cumulative total deficit of almost $800 billion and the last two years' deficits pushed the total for the decade above $1 trillion (using the CIF value for imports). The related loss of jobs in import-sensitive and export-oriented industries has been devastating for millions of American workers, their families and communities.

The growth of foreign investment in this country is the "flip side" of the tremendous trade deficits. The dollars received by foreigners from selling goods and services to America have not all been used to buy similar products from the U.S.; they have also been spent on a variety of assets here: U.S. government bonds; stocks and bonds of American companies; real estate (urban skyscrapers and rural farmland); buying ongoing businesses; and, establishing new businesses.

From 1980 to 1989, foreign investment in the U.S. quadrupled to $2 trillion, so that it now stands well in excess of half a trillion dollars more than the total value of U.S. investment abroad. While many economists have yawned at this transformation of the U.S. from the world's largest creditor nation to a debtor country of unprecedented proportions in about five years (most of them believe that a dollar is the same whether it's spent by an American or a foreigner and that the U.S. status as the world's largest "debtor" country is not a problem), it raises a number of crucial questions for the nation, including:

- are the jobs at foreign-owned firms different from those at U.S.-owned firms—is the skill content lower, are there fewer engineering and technical jobs, are they mostly assembly jobs;
- do foreign-owned firms treat their workers and communities fairly, obeying labor, equal opportunity and environmental laws;
- what is the political impact of U.S. companies tied to foreign firms — do they use their influence to promote foreign or domestic interests;
- are U.S. technological advances transferred abroad faster by foreign-owned firms;
- what is the actual total value of foreign ownership — it has been difficult to track down the U.S. assets owned by foreigners, such as deposed Philippines dictator Marcos;
- is the U.S. economy made more fragile and unpredictable by increased foreign investment that can be quickly transferred back home;
- will the expansion of foreign banks in the U.S. affect the economy;
- will the payment of profits, rents, interest and dividends to foreigners reduce incomes of Americans and hinder U.S. economic growth?

Taken together, these questions frame the important issue for workers presented by the growth of foreign investment — does it help produce the kind of economy that meets the needs of working people, one with full employment, a strong and diversified industrial base, high-productivity jobs with high wages and good fringe benefits? Millions of Americans are concerned that the nation's economic future will offer less opportunity to improve living standards and that they will have less control over their own economic destiny because of the rapid expansion of foreign investment and ownership of U.S. businesses. We commend the Chairman and the Committee for recognizing the importance of this issue and undertaking further examination.

While the majority of foreign investment is of a portfolio nature, it is the investment in assets controlled by foreign investors, foreign direct investment, that is more controversial because it involves control of productive capacity in the U.S. economy, the types of jobs created and the goals of employers. The most important of these investments to autoworkers have been the "transplant" operations set up by Japanese auto and parts producers. Since 1982, Japanese firms have established eight assembly plants in the U.S., including two that are joint ventures with U.S.-based assemblers, and three in Canada, one of which is a joint venture. Hyundai, the Korean auto maker, has also opened a Canadian assembly plant. The single European-owned U.S. assembly plant (Volkswagen) closed in 1989 after ten years in operation. There are also an estimated two hundred new plants set up by foreign auto parts producers in the U.S. and Canada. Most of these are owned by Japanese firms and a significant number have U.S.-based firms as joint venture partners. At present, the Japanese assembly plants are the main customers of the new parts plants.

Unfortunately, the information on foreign direct investment that is currently available through various federal government agencies is not sufficient to provide adequate answers to the questions posed above. As an example, the auto investments I have just described do not appear in the U.S. data as "manufacturing" or "transportation equipment" investments; most of them are described as investments in "wholesale trade" because the companies making the investments previously only sold cars in the U.S. Legislation that passed the House of Representatives in the last Congress, sponsored by Rep. John Bryant (D-Texas), would have required foreign individuals or firms making substantial investments in the U.S. to notify the government of such investments.

If the information covered in the Bryant Amendment were being collected, it could be used to produce studies on specific industries and the behavior of foreign-owned or controlled firms to answer the questions cited earlier. This should be the starting point in determining the impact of foreign investment on the U.S. economy and American workers.

The Reagan Administration and lobbyists representing foreign governments and companies and U.S. multinational corporations strongly opposed the collection of more information. They claimed that requiring submission of such information was the same as restricting or discouraging foreign investment. They assume that more foreign investment is desirable for the U.S. economy, even though the lack of information makes a realistic analysis of the impact of that investment impossible to carry out. In addition, it is revealing that most of the foreign companies investing in the U.S. come from countries such as Canada, France, Japan, South Korea and Mexico which impose requirements on foreign investors within their borders at least as stringent as those the Reagan Administration opposed here. In many countries, the government has the authority to reject a proposed investment or make substantial demands on the investor for technology transfer, domestic content, product exports and other items. Our major trading partners clearly do not have unqualified faith in the benefits of foreign investment.

While the lack of information hampers our understanding of the way foreign investment affects America's economic life, there are some generalizations about it that can be made. First, it is important to recognize that there are circumstances under which foreign investment can be beneficial. If investment in the U.S. by foreign companies creates the ability to replace U.S. imports with domestic production, that can help American workers. The purpose of the domestic auto content legislation that passed the U.S. House of Representatives in 1982 and 1983 with strong UAW support was to require foreign auto producers to domestically produce the vehicles they sold in the U.S. The decisions of Japanese auto producers to build U.S. plants were encouraged by the UAW as a way to reduce the auto trade deficit without reducing competition here.

Thus far, without the force of law, this approach has been unsuccessful. Imports have remained high and the domestic parts value in the transplants assembled here is too low. This has sent the U.S. trade deficit higher, cut back the market for U.S.-made auto parts and reduced auto industry employment.

While there are many new U.S. assembly plants (transplants) that have been built by foreign-owned auto producers, the competition for contracts to supply parts, components and materials to them has been far from open. Most of these parts are shipped to the transplants by the Japanese parents' traditional suppliers — from Japanese and other foreign plants and from new U.S. facilities built by the supplier companies. Existing U.S auto parts suppliers have complained about their inability to receive fair treatment from the purchasing departments of the transplants.

A variety of studies, including one by the UAW, have documented the high level of foreign value in the transplants. The most recent addition to this information came from Congress's General Accounting Office this past summer. It indicated that 38 percent of the parts value in transplant vehicles comes from North American sources, which include the newly-established plants of their traditional suppliers.

With the U.S. auto sales market at best stagnant and widely recognized as poised for a serious decline, the expansion of transplant production comes at the expense of vehicles made by U.S.-based producers. The domestic parts value in these cars is typically 80-90 percent, far in excess of the level in the transplant vehicles that replace them. Imports of vehicles have remained high even as transplant production has grown. Any hope that the transplants would replace imports rather than domestic output appears unfounded.

Our assessment of this pattern of foreign investment in the auto industry is that it has been disadvantageous for American workers. Transplant vehicles contain less local parts value, reducing the need for U.S. parts workers; new transplant suppliers hire new workforces and displace workers at existing domestic suppliers; investment in infrastructure and incentives by state and local governments for the new investors diverts funds from other needed public expenditures; and, the new plants add to existing excess capacity in the auto industry. For auto workers, their families and communities, foreign investment has brought fewer jobs overall, significant displacement of current workers and a worsening trade deficit.

Foreign investment that serves to strengthen the foreign operations of a company (the acquisition of new technology, use of U.S. profits to invest abroad, short-term financial gain, a new market for parts production, etc.) or to eliminate U.S. competitors may hurt American workers and weaken the U.S. economy. We are seeing this in the U.S. auto industry today. The impact of the present slump in auto sales on U.S. employment is exacerbated by the new capacity that has been added recently. Layoffs are up sharply in January and a replay of the massive economic disruption of the industry in the early 1980's is possible.

The solution to this situation is more U.S. production by these companies and fewer U.S. imports, so that domestic producers are not squeezed out of the market and domestic capacity can be fully utilized. The additional high wage auto jobs created would strengthen the U.S. industrial base.

It is clear that, in the face of the influx of foreign capital into the U.S., our political system must be capable of distinguishing between the interests of companies with U.S. operations and the interests of U.S. workers. The growth of U.S.-based multinational corporations taught American workers that they could not expect their employers to always promote the interests of the U.S. economy. Often, multinationals support policies that weaken the U.S. economy, such as when they oppose temporary import restraints, but assure higher worldwide profits for the corporation. Foreign-owned companies and companies with foreign investors may also be more concerned with the effect of U.S. economic and trade policies on their home-country operations than on their U.S. investments. Adding these two foreign-oriented groups of business interests together makes for a dangerous political situation, as evidenced by the successful lobbying against the Bryant legislation. The individuals in the Congress and Administrative agencies where economic and trade policy are made or executed must understand that those speaking on behalf of "business" are not necessarily speaking for American production and employment. Those appearing before you as witnesses who ignore this distinction and emphasize the primacy of the "global" economy should be asked to identify whose interests they are paid to represent and what commitments they and their clients have made to other governments, in formal or informal negotiations.

A major factor contributing to the political system's difficulty in separating U.S. from foreign interests is the frequency with which high government officials leave to take jobs representing foreign governments and companies. They use their government service in the Congress or in trade-related agencies in the Executive branch as a stepping-stone to the high fees paid for such lobbying, advisory and legal work. The Reagan Administration and its predecessors spawned a host of "entrepreneurs" now working for foreign interests.

Legislation passed by the Congress just before adjournment last year tightened the rules for contacts by former congressional and Administration officials with their successors on behalf of foreign clients by a bit. Further restrictions are needed to prevent government officials from seeking to sell their expertise and influence in the policy-making process to the highest bidder.

Adding to the difficulty in sorting out the interests of the U.S. economy is the self-defeating competition among the states for foreign investment. A variety of incentives have been offered to foreign companies to induce their location in one state rather than another. The U.S. economy gains nothing from the bidding wars that have taken place — the investments would, in almost every instance, be made somewhere in the U.S. to take advantage of the opportunities here even if no incentives were offered.

Site purchase and preparation, tax holidays, subsidized hiring and training and various other state and local programs drain resources from needed public projects. At the same time, they contribute to lower business costs for the foreign investor, making it easier to take business from existing U.S. competitors. In many states, the advantages provided to foreign investors are not even available to businesses already operating in the state that may want to shore up their capacity or expand.

State and local governments are effectively subsidizing companies that, generally, source less of the value of their products in America than the companies they supplant. This is a losing strategy for the U.S. There must be federal standards that regulate state and local development programs. The goal of such standards would be to insure that any programs bring additional jobs to, and strengthen the industrial base of, the nation. Continuing the present competition will only weaken that base, which is a vital source of economic health.

The massive amounts of foreign investment will have a lasting impact on the U.S. economy. The world economy is, indeed, becoming more interdependent, making it more difficult to determine how the U.S. government can effectively enhance U.S. economic performance and raise living standards at home and around the world. Increased foreign investment around the world has payed a part in this process. The experience of the 1980's has shown that the laissez-faire approach to trade and investment does not benefit the majority of workers, here or abroad. To improve on this performance, our government must act from knowledge and understanding of international economic and financial conditions, not ignorance, with the goal of achieving beneficial results, not satisfying ideological dictates. To do that, first, there must be much more and better information available on the total amounts of foreign investment in the U.S. as well as on U.S. investment abroad and more extensive empirical analysis of the impact of different types of foreign investment on the U.S. economy, wage levels, job security and overall employment as well as on specific industries.

Second, the foreign investment issue cannot be successfully addressed until the U.S. trade deficit has been erased. The growing holdings of dollars and U.S. investments by foreigners will continue to pile up as long as the deficit remains. Economists with widely differing views on the net effect of foreign investment agree that the U.S. cannot remain dependent on infusions of capital from abroad of more than $100 billion annually to maintain economic growth. The only answer to this problem is rapid, steady progress toward U.S. trade balance with the rest of the world. The UAW has supported a variety of policies aimed at restoring balance to U.S. trade accounts and fundamentally altering U.S. trade policy to focus on the long-term health of the economy and its industrial base. The Congress has shown its recognition of the importance of action on trade by passage of the 1988 omnibus trade legislation and its monitoring of the implementation of that law. The UAW hopes that this session of Congress will be willing to take further action to address the problem.

Third, the difference between the "national" interest and both "corporate" and "global" interests must be fully understood by those shaping international economic policy for the U.S. in the Congress and the Bush Administration. Other countries have no difficulty in engaging in hard-nosed, results-oriented bargaining to achieve national economic development goals. We must not allow the economic future of America's workers to be bound by a commitment to an obsolete ideology and excessive influence on our policy-making process by individuals and groups with primary concern for private profits or foreign interests. In advising this approach, the UAW is not arguing that U.S. economic growth must come at the expense of growth elsewhere in the world. To the contrary, raising the incomes of workers abroad is supported and sustained by expanding the productivity and purchasing power of American workers. The economic policies proposed by multinational corporations and foreign interests generally fail to promote this objective; their blanket endorsement of foreign investment in the U.S. must, therefore, be subject to further scrutiny.

Fourth, the state and local government rush to subsidize foreign investment must be controlled by federal action. There is no satisfactory economic rationale for this activity. Besides being wasteful, it stimulates over-investment in new production capacity that creates less value in the U.S. than existing facilities and displaces current workers with accumulated job-related skills.

We are hopeful that the Committee's hearings on the implications of foreign investment for the U.S. economy will lead to the recognition that the U.S. must develop its own strategies for strengthening the nation's industrial base. Such strategies must recognize the presence of foreign investors and provide a role for them as well as for U.S.-based producers in contributing to a full employment, high productivity, high wage economy.

The public discussion of the effect of the dramatic increase of foreign investment has been joined. The UAW, with thousands of members at foreign-owned firms, will continue to play an active role in this discussion. It is not time to panic and assume that the U.S. has lost control of its economic destiny, but it is equally inappropriate to assume that this will all work out for the best without any guidance from government.

Mr. Chairman, I would also like to comment briefly on Europe 1992 as it affects American workers and UAW members, as well as on its implications for foreign direct investment.

The integration of the twelve EC country markets, presented as a way to promote competition, increase efficiency and stimulate growth, has a "social dimension" that has been given insufficient attention thus far. The creation of increased economic competition and the scaling down of impediments to moving production and employment from country to country that national governments have imposed on companies puts workers in previously distinct labor markets into competition as well. Workers in countries in which unions have succeeded in winning relatively high wages, safe workplaces, generous social programs (unemployment compensation, training, pensions, etc.) and an extensive role for workers in corporate decision-making are concerned that employers will shift their jobs to countries that have made considerably less progress toward these goals. Such a shift could drive down labor standards and protections where they have been raised and prevent improvements where standards are low. The European Trade Union Council (ETUC) has called on the EC to adopt directives that protect the high national standards that have been achieved and set minimum standards for other countries to meet over time.

It is worth considering the relevance of the European discussion of social policy for the U.S. economy and American workers. In the first place, the European debate resembles U.S. discussions of deregulation and de-federalization in the early 1980's. The path taken by the U.S. has led to declining living standards for millions of workers, their families and communities, increased competition between states for new investment, the growth of low-paid jobs and the disappearance of well-paid jobs, a massive budget deficit and a dangerous trade deficit. European companies would like to make the 1992 market integration into a repeat of the pro-business bonanza the U.S. has experienced; European unions are looking for an alternative path of economic development based on high wages, workplace protections and respect for the rights of workers.

The UAW and other American unionists strongly endorse the proposals of the ETUC. Reducing the living standards of European workers would add to the already intense pressure employers thrive on to drive down workplace, environmental and social standards. The UAW has supported the improvement of the conditions of work throughout the world in our 50 year history. Most recently, we have focused on government repression of worker rights in newly industrialized countries. We have no less concern for European workers; they should be winning further gains in employment conditions and industrial democracy.

If the ETUC social program for 1992 is not adopted, we can expect more intense pressure from employers on U.S. labor standards. The "competitiveness" challenge on the basis of labor costs will be broadened to include the EC; competition based on ingenuity and product quality, which require a well-trained, well-paid workforce, will be set back. We must forcefully reject visions of a world economy in which absolute cost is the primary criterion in determining the location of production. With the sophistication in technology available and the ease of introducing it anywhere in the world, companies have become extremely adept at pitting potential investment sites and their workforces against each other in order to reduce their own costs. Workers never win in this competition, nor, in the longer run, do the companies. The impoverishment of workers results in fewer customers and declining sales, not lower cost and increased sales. We sincerely hope this is a lesson that can be learned in Europe and here at home, before it is too late.

With respect to auto trade, the integration of the EC auto market calls into question the existing market-restricting arrangement. There are five EC countries that restrain imports of vehicles from Japan (France, Italy, Great Britain, Spain and Portugal); an overall EC restraint is also in effect, protecting those countries that have no agreement with Japan. Although this EC-wide restraint has been in effect for years, I frequently encounter Executive branch, congressional and private sector officials who are unaware of it.

The EC will likely maintain its restraint of imports from Japan at about 10 percent of the market (while the share of Japanese imports in the U.S. market is about double that) until 1992. The restraint would then continue for years (seven years has been mentioned) at a relatively low level as the individual country restrictions are eliminated. The EC imposes far more restrictive access to its market on imports of vehicles from Japan than the U.S., and it will continue to do so. This should be recalled when attacks on the "protectionist" U.S. are heard in Europe. The EC auto producers are pushing to keep some restrictions in place until European exports to Japan reach five percent of Japan's auto market.

There is a very intense debate within the EC over the treatment of vehicles produced in Europe by Japanese companies. The European auto producers are pressing to consider all such vehicles imported from Japan unless their content is 80 percent European. In addition, fear of the impact of adding to the industry's excess capacity has led some European governments to discourage more investment by Japanese producers. This is an undisguised effort to keep production and employment at European-based firms from falling. It is even presumed that U.S.-assembled transplants shipped to Europe would be considered Japanese in origin.

We do not believe the Europeans are pursuing the wrong policy; it is reasonable to be concerned about excess capacity and worker displacement. As the world's largest auto market and a net exporter of cars, however, the EC should take some responsibility for resolving the worldwide excess capacity problem rather than focusing only on its internal priorities.

With respect to the broader question of the relationship between the EC 1992 program and investment in Europe by U.S. firms, it seems clear that the ongoing rumors of the creation of a "Fortress Europe" encourage American firms to locate production facilities within the EC. I have personally heard the U.S. ambassador of an EC member country minimize the likelihood of Europe's policy toward U.S. exports becoming more restrictive and then blithely advise any firm that had any doubts on this score to resolve them by investing in Europe. The EC gains investment by keeping doubts alive. Yet the EC's negative position on additional Japanese investment in the auto industry shows that its approach to foreign investment is selective and calculated.

The UAW and the American labor movement have a strong interest in assuring fair treatment for U.S. exports to Europe; we will support congressional and Administration efforts to secure it. We also recognize that the EC is looking out for its own economic interests in trying to induce additional investment. Only when the U.S. similarly recognizes its own economic interests and makes credible efforts to defend those interests when they are compromised will the EC and other trading nations seriously negotiate, and abide by, international rules regarding trade and investment.

Mr. Chairman, I appreciate this opportunity to testify on behalf of the UAW and welcome any questions that you and members of the Committee may have.

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Mr. GUARINI. Dr. Rosenblatt, the Association for International Investment.

STATEMENT OF SAMUEL M. ROSENBLATT, PH.D., PRESIDENT, ASSOCIATION FOR INTERNATIONAL INVESTMENT

Mr. ROSENBLATT. Thank you.

My name is Samuel M. Rosenblatt. I am president of the Association for International Investment, on whose behalf I appear today.

AFII is a partnership of the United States affiliates of foreign investors, U.S. multinational corporations, and State and local governments concerned with maintaining the freedom of international investment in response to market forces.

AFII supports the fundamental policy of the U.S. Government, which welcomes market-driven international direct investment and which seeks to lower barriers to American investment abroad.

In response to the committee's announcement, I have confined my remarks to three principal questions on international investment: What have been the recent trends in foreign direct investment into the United States and what factors have been driving this investment? What is the relationship between the U.S. fiscal deficit, its trade, or current account deficit, and the inflow of foreign capital? Has foreign direct investment helped or harmed the U.S. economy?

In assessing this issue, it is important to note that, for the United States, international investment has been a two-way flow. On a global basis as of the end of 1986, the United States was the home country for 33 percent of direct international investment and absorbed 27 percent of this investment as host country—by far the largest in both categories. Even though the absolute dollar magnitudes of annual capital flows into the United States have risen in the 1980's, the relative growth in foreign direct investment in this period is consistent with growth in the 1970's.

Foreign direct investment in the United States through the 1950's and 1960's came in at around 6.5 to 7.5 percent a year. This rate of growth accelerated sharply beginning in the 1970's to as much as 20 percent a year, above the 1980's 18.8 percent. For the United States, obviously, the investment patterns were reversed with larger U.S. investments abroad in the 1950's and 1960's and then declining as a relative rate in the 1970's and 1980's. These contrasts are, of course, consistent with the shifting economic fortunes among industrial countries. From the end of World War II through the mid-to-late 1960's, the United States was the preeminent global economic power. The fact that Western Europe and Japan are now providing a larger share of global investment capital is one consequence of U.S. policies that promoted those countries' recovery as essential to an open and expanding global economy.

In spite of the recent large dollar flows of foreign investment into this country, foreign ownership still represents a small portion of U.S. wealth. As of 1988, this number was only about 2.2 percent.

The global marketplace has made it impossible for multinationals—whether United States or foreign—to ignore the potential benefits of establishing subsidiaries abroad.

In order to succeed here, a non-U.S. business must possess some firm-specific advantage that will enable it to compete effectively. This perceived advantage may stem from any of a variety of sources, such as ownership of particular technologies, superior control over production processes, unique marketing or distribution strengths, or a reputation for a better quality product.

It is apparent that the attractiveness of the U.S. economy, due to its political stability, openness, size, and growth potential will continue to motivate non-U.S. businesses to invest here. But these attractions could be overcome if we were to develop an unfriendly investment climate. In our view, it is important that Congress nip in the bud protectionist policies that might deter foreign investment.

The presence of foreign capital through the 1980's has enabled the United States to avoid confronting a Hobson's choice between inflation or recession. Absent this pool of foreign capital, under prevailing U.S. fiscal conditions, the United States would have to balance the shortfall between gross saving and gross private domestic investment either by excessive monetary ease—to generate a larger pool of loanable funds—or excessive monetary restraint—to restrict the private demand for capital.

Thus, it was the net inflows of foreign investment capital rather than inflation or recession that enabled the Nation to achieve an equilibrium between savings and investment.

Let me talk a little bit about some of the benefits of foreign investment. There were 3.2 million U.S. workers employed at nonbanking U.S. affiliates in 1987—more than 1.5 million at manufacturing affiliates. Foreign direct investment promotes real growth and increases the competitiveness of U.S. industry. It adds to the industrial capacity of the economy by expanding and upgrading the Nation's stock of new plant and-equipment.

The research and development [R&D] spending by U.S. manufacturing affiliates, as a percent of sales, has been above or nearly equal to that by all U.S. manufacturers.

A large part of the imports of U.S. affiliates of foreign parents are handled by firms classified as wholesalers. These imports are intended for resale without further manufacturing. Thus, it would be incorrect to attribute all of these imports to the actual investment transactions themselves.

In conclusion, all of the foregoing suggests that American policy toward international investment should remain on the path adopted at the close of World War II; namely, a continuing effort to break down the international barriers to the free flow of capital in response to market opportunities. AFII believes that foreign investors make a positive and much-needed contribution to our State and local communities as well as to the national economy. We are also convinced that freedom of investment abroad, which is so important to U.S. economic and business objectives, cannot be maintained if we start closing doors here at home.

I thank you for the opportunity to testify today and I welcome any questions you may have.

Mr. GUARINI. Thank you very much, Mr. Rosenblatt.

[The statement of Mr. Rosenblatt follows:]

WRITTEN STATEMENT
of
SAMUEL M. ROSENBLATT
of the
ASSOCIATION FOR INTERNATIONAL INVESTMENT

on

FOREIGN DIRECT INVESTMENT AND THE U.S. ECONOMY

before the

COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

January 25, 1990

I. INTRODUCTION

Good afternoon, Mr. Chairman. My name is Samuel M. Rosenblatt. I appear on behalf of the Association for International Investment ("AFII"), a partnership of the U.S. affiliates of foreign investors, U.S. multinational corporations, and state and local governments concerned with maintaining the freedom of international investment in response to market forces. My training as an international economist has led me to hold the views that AFII espouses.

Like U.S. industry generally, AFII's members recognize two fundamental and interrelated facts: they understand the need to attract investors to the United States to meet this country's requirements for investment capital, and they are concerned that the erection of barriers to international investment would lead to reciprocal action by other governments with serious adverse consequences for the ability of American companies to do business abroad. AFII supports the fundamental policy of the U.S. Government, which welcomes market-driven international direct investment and which seeks to lower barriers to American investment abroad.[1/][2/]

We understand that these hearings are part of the Committee's broad effort to address trade-related developments affecting the U.S. economy. AFII is concerned with one of these developments -- the international movement of investment capital -- and my remarks today will be confined to this subject. The three principal questions to be addressed are:

-- What have been the recent trends in foreign direct investment flows into the U.S. and what have been the factors driving these flows?

-- What is the relationship between the U.S. fiscal deficit, its trade, or current account deficit, and the inflow of foreign capital?

[1/] See Statement by the President on International Investment Policy 4 (September 9, 1983).

[2/] See Written Statement of Elliot L. Richardson, Chairman, Association for International Investment, Subcommittee on Economic Stabilization, Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, November 15, 1989.

-- Has foreign direct investment helped or harmed the U.S. economy?

II. RECENT FLOWS OF FOREIGN DIRECT INVESTMENT

A. Trends in Foreign Direct Investment

In assessing this issue, it is important to note that, for the United States, international investment has been a two-way flow. As of the end of 1986, the U.S. accounted for 33 percent of direct international investment abroad, as home country, and absorbed 27 percent of this investment -- by far the largest in both categories.[3] Investment flows since 1986 may have modified these percentages but are unlikely to have altered the rankings.

In 1988, the value of foreign direct investment in the U.S. surpassed that of U.S. investment in other countries. By September 30, 1989, according to AFII estimates, the "book" value of foreign direct investment was $372.7 billion, while the comparable value of U.S. direct investment abroad was $349.1 billion (See Table 1.)

Considerable attention has been focused recently on the large annual flow of foreign direct investment into the United States. To some, these inflows indicate a weakening of our economy. I believe, however, that there is little cause for alarm. Among other things

- the pace at which foreign direct investment has risen in the 1980s is consistent with earlier trends;
- foreign direct investors hold a relatively small share of the U.S. economy; and
- when measured at current market value rather than book value, U.S. direct investment abroad still exceeds foreign direct investment in this country.

1. Relative Growth in International Investment

Even though the absolute dollar magnitudes of annual capital inflows have risen in the 1980s, the relative growth in foreign direct investment between 1980 and 1988 is consistent with growth in the 1970s. As may be seen in Table 2, foreign direct investment in the U.S. grew rather slowly through the 1950s and 1960s -- at around 6.5 to 7.5 percent a year. The annual rate of growth accelerated sharply beginning in the 1970s. In the 1970s, foreign direct investment actually rose at a faster rate -- 20.1 percent -- as compared with the 18.8 percent annual rate in the 1980s. For comparative purposes, data on growth patterns of U.S. direct investment abroad are also shown. For the U.S., these patterns are the reverse of those for foreign direct investment here, with more rapid increases in the 1950s through the 1970s and then slowing in the 1980s.

These contrasting patterns are, of course, consistent with the underlying economic realities among industrial countries. From the end of World War II through the mid-to-late 1960s, the U.S. was the preeminent global economic power. The fact that Western Europe and Japan are now providing a larger share of global investment capital is a consequence of U.S.

3/ U.S. Dep't Commerce, International Trade Administration, "Staff Report Direct Investment Update: Trends in International Direct Investment", 1 (Dec. 1988).

policies that promoted those countries' recovery as essential to an open and expanding global economy.

2. Foreign Ownership Represents A Small Share of the U.S. Economy

In spite of the recent large dollar flows of foreign direct investment from abroad and the expanded operations of U.S. affiliates in this country, foreign ownership represents a small portion of U.S. wealth. For example, foreign direct investment represented only 2.2 percent of all U.S. net domestic wealth in 1988.[4] Similarly, the share of national output accounted for by U.S. affiliates of foreign investors, while increasing, has remained small. In 1977, the operations of foreign-owned businesses produced 2.1 percent of the nation's output, while in 1987, the most recent year for which data are available, this share had risen to 3.9 percent.[5]

Within the manufacturing sector, the share of ownership and activity of U.S. affiliates is somewhat higher. Sales of U.S. manufacturing affiliates represented 11.0 percent of all manufacturing sales in 1987, up from 5.0 percent in 1977, while the assets held by these affiliates amounted to 13.0 percent of assets of all U.S. manufacturers in 1987, as compared with 6.3 percent in 1977.[6]

3. The Market Value of U.S. Direct Investment Abroad Exceeds That of Foreign Direct Investment in the United States

The Department of Commerce, which collects data on direct investment, reports and maintains its information on the basis of the original book value of the investment. Since U.S. direct investment overseas is more mature than foreign investment here, the market value of U.S. overseas investment is relatively understated by its book value as compared to foreign holdings in this country. Indeed, estimates developed by the staff of the Board of Governors, Federal Reserve System, place the market value of U.S. overseas direct investments at almost $742 billion as of the end of 1988, with the market value of foreign direct investment in the U.S. at $400.6 billion.[7]

B. Economic Factors Prompting Foreign Businesses To Invest in the United States

The global marketplace has made it impossible for multinationals to ignore the potential benefits of establishing subsidiaries abroad. Initially, non-U.S. multinationals may have been able to service the American market through exports from their home countries just as U.S. companies had been able to service a foreign market from the U.S. Eventually, however, the intensification of competition, the growing technical complexity of products, and the need to be closer to customers required facilities in various markets, including America.

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[4] AFII extrapolation from Board of Governors of the Federal Reserve System, Balance Sheets for the U.S. Economy 1949-1988 at 5 (Oct. 1989).

[5] AFII extrapolation from U.S. Dep't Commerce, "Foreign Direct Investment in the United States Gross Product of Nonbank U.S. Affiliates of Foreign Companies 1977-1986" and unpublished data.

[6] U.S. Dep't Commerce, Survey of Current Business, 64 (May 1988) and 21 (December 1989).

[7] L. Stekler and W. Helkie, "Implications for Future U.S. Net Investment Payments at Growing U.S. Net International Indebtedness," International Finance Discussion Papers, Board of Governors, Federal Reserve System, 14b (July 1989).

In order to succeed here, a non-U.S. business must possess some firm-specific advantage that will enable it to compete effectively. This perceived advantage may stem from any of a variety of sources, such as ownership of particular technologies, superior control over production processes, special marketing or distribution strengths, or a reputation for a better product quality. All foreign businesses need such advantages to overcome the natural advantages of its competitors who face no linguistic or cultural barriers.

It is apparent that the attractiveness of the U.S. economy, due to its political stability, openness, size, and growth potential will continue to motivate non-U.S. businesses to invest here. But these attractions could be overcome if we were to develop an unfriendly investment climate. In our view, it is important that Congress nip in the bud protectionist policies that might deter foreign investments.

III. RELATIONSHIP BETWEEN U.S. FISCAL AND TRADE DEFICITS AND FOREIGN CAPITAL

The presence of foreign capital through the 1980s has enabled the U.S. to avoid confronting a Hobson's choice between inflation or recession. Absent this pool of foreign capital, under prevailing U.S. fiscal conditions, the U.S. would have to balance the shortfall between gross saving and gross private domestic investment either by excessive monetary ease -- to generate a larger pool of loanable funds -- or excessive monetary restraint -- to restrict the private demand for capital. The former approach would have led to price escalation and inflation, while the latter would have meant large losses of jobs and income.

In a macroeconomic sense, therefore, the net inflows of foreign capital that began in 1982 contributed to seven years of uninterrupted prosperity. This capital offset the shortfall between gross saving and gross private domestic investment. This shortfall was due principally to a decline in private saving and the growth and persistence of the federal deficit, both of which drew down the nation's gross savings pool, and the comparative strength of private investment relative to gross national product.

Gross saving averaged only 12.8 percent of national output over the 1985-1988 period, as compared with a 15.2 average from 1980 through 1984. (See Table 3.) This decline was caused by the falloff in gross private saving and the moderate increase in the fiscal deficit (dissaving) as a percentage of gross national output. Gross private saving averaged 17.5 percent of output from 1980 through 1984, whereas it was only 15.5 percent of output over the 1985-1988 period. In addition, the U.S. Government fiscal deficit, measured as a share of national output, increased from 3.7 percent to 4.1 percent over these two time periods. With private domestic investment remaining between 15.9 and 15.6 percent of output for 1980-1984 and 1985-1988, respectively, net inflows of foreign investment capital were the only way -- other than inflation or recession -- to achieve an equilibrium between savings and investment.

Annual net foreign investment inflows must necessarily track the U.S. current account deficit. This parallel movement is shown in Table 4. Trends in the U.S. merchandise trade deficit are also shown in Table 4. The trade deficit, of course, has been the principal contributor to the nation's current account deficit. From 1982 through 1988, the cumulative total for the merchandise trade deficit has been more than $770 billion, while those for the current account and the net foreign investment deficits have amounted to almost $672 billion and $643 billion, respectively, over the same time period.[8] The dollars accumulated abroad due to this excess of U.S. imports over U.S. exports have become dollar-denominated assets held in foreign hands.

Reducing the U.S. trade deficit is a desirable goal in and of itself. It would also go a long way towards lessening the net inflows of foreign capital. However, this does not mean that if the merchandise trade deficit were somehow erased overnight, the flow of foreign direct investment would cease. As touched upon previously, non-U.S. international businesses will continue to be attracted to the U.S. for a number of sound commercial reasons. Of course, a lessening of the U.S. trade deficit would alter the economic environment in the United States and this could affect the anticipated risk/reward assessment associated with investments in this country.

IV. FOREIGN DIRECT INVESTMENT CONTRIBUTES TO THE U.S. ECONOMY

The macroeconomic benefits of foreign investment were described above. Foreign investment, like domestic investment, also contributes in other ways. There were 3.2 million U.S. workers employed at nonbanking U.S. affiliates in 1987.[9] Of this number, more than 1.5 million were employed at manufacturing affiliates.[10] Indeed, employment at U.S. manufacturing affiliates increased by 37 percent between 1980 and 1987,[11] while employment for all U.S. manufacturers declined 6.4 percent over this period.[12] Foreign direct investment also promotes real growth and increases the competitiveness of U.S. industry. It adds to the industrial capacity of the economy by expanding and upgrading the nation's stock of new plant and equipment.

International investors are generally among the most successful companies in their home countries. They are at the cutting edge of new products, new production technologies and processes, as well as new management methods. One illustration is that research and development ("R & D") spending by U.S. manufacturing affiliates, as a percent of sales, has been above or nearly equal to such spending by all U.S. manufacturers. (See Table 5.) In addition, Department of Commerce data on U.S. affiliates' payments and receipts for royalties and license fees indicate that more technology and other technical support are being shipped into U.S. affiliates from abroad than U.S. affiliates are shipping overseas. (See Table 6.)

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[8] U.S. Dep't Commerce, Survey of Current Business, 63 (June 1989) [hereinafter June Survey].

[9] U.S. Dep't Commerce, Survey of Current Business, 117 (July 1989) [hereinafter July Survey].

[10] *Id*. at 119.

[11] U.S. Dep't Commerce, Foreign Direct Investment in the United States 1980 Table F-3 (Oct. 1983) [hereinafter Benchmark 1980] and Foreign Direct Investment in the United States 1987 Benchmark Survey, Preliminary Results Table F-4 (July 1989) [hereinafter Benchmark 1987].

[12] Economic Report of the President 1989 356 (Jan. 1989).

The data suggest that the foreign parents of these U.S. affiliates are intent on building them up to be able to compete more effectively, a fact that is consistent with the proposition that foreign parents are committed to remaining in the U.S. for the long term.

The merchandise trade performance of U.S. affiliates of foreign parents is another indication of the role that foreign investment plays in the U.S. economy. There is no doubt that these businesses are heavily involved in international trade. Further, the raw totals of this trade show that U.S. affiliates are importing much more than they export. In 1987, the latest date for which data are available, U.S. affiliates had total exports of $47.9 billion, while their imports were in excess of $140.6 billion, which works out to a net trade deficit of $92.7 billion.[13/] The total U.S. merchandise trade deficit in 1987 was $159.5 billion.[14/] This does not mean that U.S. affiliates were responsible for fully 58 percent of the U.S. trade deficit in that year. Such a conclusion would be misleading since it fails to take into account the underlying reasons for this trade and the sectoral classification of the businesses involved.

Of the $140.6 billion in imports, $105.3 billion, or almost 75 percent, were imported by U.S. affiliates classified in wholesale trade. Of this $105.3 billion, $86.4 billion, or 82 percent were of goods for resale without further manufacture. For all imports by U.S. affiliates -- or $140.6 billion -- almost 69 percent, or $97.0 billion, were intended for resale.[15/] Subtracting these imports from the total leaves approximately $43.6 billion, which is below the overall exports of $47.9 billion by U.S. affiliates. These classifications indicate that very large percentages of imports by U.S. affiliates would have occurred in the absence of foreign direct investment in the U.S. Thus, it would be incorrect to attribute these imports to the actual investment transactions themselves. The bulk of these products would have entered the U.S. distribution system in any event.

The imports and exports of U.S. affiliates of foreign parents within the manufacturing sector itself are also revealing. As compared with overall U.S. trade in manufactured goods since 1980, exports by non-U.S.-owned manufacturing affiliates have grown at a considerably faster rate than have all U.S. exports of manufactured goods. (See Table 7.) Further, and perhaps contrary to the general perception, imports by U.S. manufacturing affiliates of foreign firms rose less rapidly than did overall U.S. imports of manufactures. (See Table 8.)

Another way of viewing the comparative trade performance of U.S. manufacturing affiliates is through a ratio that measures the deficit in this trade to the total of their two-way import and export trade against a similar ratio for all U.S. trade in manufactured goods. As may be seen in Table 9, it is clear that the trade performance of U.S. manufacturing affiliates is marginally better than all U.S. trade in manufactures in terms of contributions to the U.S. trade deficit.

[13/] Benchmark 1987, supra note 10, at Table G-2.

[14/] June Survey, supra note 7, at 63.

[15/] Benchmark 1987, supra note 10, at Table G-3.

Finally, a growing share of imports by U.S. manufacturing affiliates is of goods that these firms subject to further processing and manufacture in this country. This means more domestic value added and more local generation of jobs and income.[16]

The Committee has asked to what extent foreign investment limits the flexibility of U.S. economic policies. Critics of foreign investment in this country have sometimes cited the high percentage of foreign ownership in certain sectors of the U.S. economy as one indicator of lessened control for the U.S. One such sector frequently noted is chemicals and allied products. In that sector, in 1987, U.S. affiliates of foreign owners held 30.9 percent of all assets and 31.2 percent of sales.[17] This high degree of dominance, it is suggested, makes the U.S. chemical industry susceptible to foreign control.

What tends to be lost sight of in these discussions is that foreign ownership in the chemical industry is not monolithic, but rather is widely dispersed both across nationalities and among companies from the same home country. The largest diversified chemical producer -- DuPont -- is counted as foreign-owned due to the 22.9 percent Canadian ownership. One hundred percent of its assets, sales, employment is classified as foreign. Among the fifty largest chemical companies listed by Standard & Poors, ten are foreign-owned. It is hard to imagine these ten companies from seven different countries acting collectively to restrain competition. In any event, the U.S. has antitrust laws in place to guard against such eventualities.

V. CONCLUSION

The foregoing suggest that American policy towards international investment should remain on the path adopted at the close of World War II -- namely a continuing effort to break down the international barriers to the free flow of capital in response to market opportunities. These are the goals the U.S. Government is pursuing currently in the Uruguay Round of GATT negotiations. As the Committee is well aware, in response to a U.S. initiative, the GATT is considering a way to deal with trade-related investment measures, or "TRIMs."[18]

AFII believes that foreign investors make a positive and much-needed contribution to our state and local communities as well as to the national economy. We are also convinced that freedom of investment abroad, which is so important to U.S. economic and business objectives, cannot be maintained if we start closing doors here at home.

In short, the most appropriate policy on foreign investment to recommend, based on economic analysis, is that the U.S. adopt a fiscal policy that will achieve a gradual reduction in the U.S. fiscal deficit. The U.S. should continue to welcome foreign direct investment. Adopting new policies that would impede the flow of capital in and out of the U.S. would most certainly be counterproductive and contrary to the best interests of U.S. business, U.S. workers, and the U.S. public.

16/ See Benchmark 1980, supra note 10, at Table G-30 and Benchmark 1987, supra note 10, at Table G-30. The percentage of imports for manufacturing firms subjected to further processing rose from 57 percent to 76 percent from 1980 to 1987.

17/ July Survey, supra note 8, at 131.

18/ Submission of the United States to the Negotiating Group on Trade-Related Investment Measures 1 (June 1987).

TABLE 1

Direct Investment
U.S. and Foreign
1980 - September 30, 1989

($ billions)

	U.S. Investments Abroad	Foreign Investments in the U.S.
1980	215.4	83.0
1981	228.3	108.7
1982	207.8	124.7
1983	207.7	137.1
1984	211.5	164.6
1985	230.3	184.6
1986	259.6	220.4
1987	308.9	271.8
1988(P)	326.9	328.9
1989(E)	349.1	372.7

(P) Preliminary
(E) AFII estimate, preliminary

Source: U.S. Dep't Commerce, Survey of Current Business (June 1989 and "Summary of U.S. International Transactions: Third Quarter 1989," Dec. 13, 1989)

TABLE 2

Direct Investment
U.S. and Foreign
1950 - 1988

($ millions)

	U.S. Investments Abroad	Foreign Investments in the U.S.
1950	11,788	3,391
1960	31,865	6,910
1970	75,480	13,270
1980	215,375	83,046
1988	326,900	328,851

Annual Rates of Growth*

(%)

1950-1960	10.5	7.4
1960-1970	9.0	6.7
1970-1980	11.1	20.1
1980-1988	5.4	18.8

*Calculated by AFII

Source: U.S. Dep't Commerce, Selected Data on Foreign Direct Investment in the United States, 1950-79 (Dec. 1984); Selected Data on U.S. Direct Investment Abroad, 1950-76 (Feb. 1982); and Survey of Current Business (June 1989)

TABLE 3

Gross and Private Saving
Gross Private Domestic Investment
Federal Deficit
and
Net Foreign Investment
as a Percentage of Gross National Product*
1980 - 1988

(Percent)

	1980-1984	1985-1988
Gross Saving	15.2	12.8
Gross Private Saving	17.5	15.5
Gross Private Domestic Investment	15.9	15.6
Federal Deficit	3.7	4.1
Net Foreign Investment	0.5	3.0

* Calculated by AFII

Source: U.S. Dep't Commerce, Survey of Current Business (July 1989) and Economic Report of the President 1989

TABLE 4

U.S. Current Account
Merchandise Trade Account
and
Net Foreign Investment
1980 - 1988

($ billions)

	Current Account	Merchandise Trade	Net Foreign Investment
1980	1.5	(25.5)	13.0
1981	8.2	(28.0)	10.6
1982	(7.0)	(36.4)	(1.0)
1983	(44.3)	(67.1)	(33.5)
1984	(104.2)	(112.5)	(90.9)
1985	(112.7)	(122.1)	(114.4)
1986	(133.2)	(145.1)	(135.8)
1987	(143.7)	(159.5)	(150.9)
1988	(126.5)	(127.2)	(117.5)

( ) Indicates deficit for current account and capital inflow for net foreign investment

Source: U.S. Dep't Commerce, Survey of Current Business (June and July 1989) and Economic Report of the President 1989

TABLE 5

Research and Development Spending
as a Percent of Sales
All U.S. Manufacturers
and
U.S. Manufacturing Affiliates
of Foreign Parents
1980 - 1987

(percent)

Year	All U.S. Manufacturers	U.S. Manufacturing Affiliates
1980	1.65	1.64
1981	1.75	2.15
1982	2.06	2.42
1983	2.20	2.51
1984	2.34	2.63
1985	2.56	2.63
1986	2.73	2.53
1987	2.60	2.56

Source: Bureau of Census, Annual Survey of Manufactures (various issues 1981-1989) and Statistical Abstract of the United States 1989 and Bureau of Economic Analysis, Foreign Direct Investment in the United States (various issues 1982-1989)

TABLE 6

Royalties and License Fees
U.S. Affiliates
Payments and Receipts
1980 - 1988

($ millions)

Year	Payments	Receipts
1980	426	48
1981	487	74
1982	394	69
1983	465	60
1984	665	68
1985	568	102
1986	773	171
1987	1,083	240
1988	1,205	238

Source: Dep't Commerce, Survey of Current Business (August, 1981-89)

TABLE 7

Exports
Manufactured Goods
U.S. Affiliates of Foreign Firms
and Overall U.S. Exports
1980-1987

(1980=100)

	U.S. Affiliates	Total U.S.
1980	100.0	100.0
1981	150.2	106.8
1982	142.4	96.6
1983	133.2	92.4
1984	144.6	101.8
1985	142.0	104.5
1986	139.0	111.9
1987	164.6	124.5

Source: Dep't Commerce, Foreign Direct Investment in the United States (various issues, 1983-1989); Dep't Commerce, Office of Trade and Investment Analysis. International Trade Administration, United States Trade Performance in 1987

TABLE 8

Imports
Manufactured Goods
U.S. Affiliates of Foreign Firms
and Overall U.S. Imports
1980-1987

(1980=100)

	U.S. Affiliates	Total U.S.
1980	100.0	100.0
1981	124.9	112.7
1982	117.0	113.9
1983	132.4	128.6
1984	171.6	174.2
1985	179.0	194.1
1986	199.7	222.6
1987	224.9	243.3

Source: Dep't Commerce, Foreign Direct Investment in the United States (various issues, 1983-1989); Dep't Commerce, Office of Trade and Investment Analysis. International Trade Administration, United States Trade Performance in 1987

TABLE 9
Imports and Exports U.S. Manufacturing Affiliates of Foreign Parents and U.S. Manufactured Goods 1980-1987

($billions)

U.S. Manufacturing Affiliates

	Exports	Imports	Net Deficit	Net Deficit as Percentage of Two-way Trade
				(%)
1980	9.0	10.4	(1.4)	(7.01)
1981	13.6	13.0	.6	1.02
1982	12.9	11.6	1.3	5.11
1983	12.1	13.8	(1.7)	(6.71)
1984	13.1	17.9	(4.8)	(15.46)
1985	12.8	18.6	(5.8)	(18.38)
1986	12.6	2.8	(8.2)	(24.63)
1987	14.9	23.4	(8.5)	(22.27)
		U.S. Manufactured Goods		
1980	160.7	138.8	21.9	7.31
1981	171.7	156.4	15.3	4.66
1982	155.3	158.1	(2.8)	(0.89)
1983	148.5	178.5	(30.0)	(9.17)
1984	163.6	241.8	(78.2)	(19.29)
1985	167.9	269.5	(101.6)	(23.23)
1986	179.9	308.9	(129.0)	(26.39)
1987	200.0	337.7	(137.7)	(25.61)

Source: U.S. Dep't Commerce, *Foreign Direct Investment in the United States* (various issues, 1983-89); U.S. Dep't Commerce, Office of Trade and Investment Analysis, International Trade Administration, *United States Trade Performance in 1987* (June 1988)

Mr. Guarini. Mr. Pease.

Mr. Pease. No questions.

Mr. Guarini. Mr. Levin.

Mr. Levin. Thank you.

Just briefly, welcome to the four of you. I think some, if not all of you, were here for Mr. Greenspan's testimony. On page 12 he didn't have time to read this portion, but he says comparison of the operations of affiliates of foreign companies with U.S. firms in the same industry indicate that R&D expenditures, wage rates, and value added do not differ systematically, only a tendency to import more clearly distinguishes affiliates from U.S.-owned companies.

However, since some foreign companies have built plants in the United States to replace imports, the net effect of direct investment on the U.S. trade balance is probably small.

Essentially just setting aside the question of direct foreign investment on the whole export-import balance is de *minimus* or close to it. Do you have any views on that?

Mr. Morris. Well, it is quite the opposite, at least in the auto parts industry, although with regard to the whole, I probably couldn't make the argument——

Mr. Levin. Speak a little closer to the microphone.

Mr. Morris. Well, what we have attempted to illustrate is not in macroterms such as Mr. Greenspan was testifying, but at least as far as Japan country-specific and automotive industry-specific, it is quite the opposite.

It has had an enormous effect and not the minimal effect suggested by Mr. Greenspan.

Mr. Levin. Yes, Steve.

Mr. Beckman. Since my experience is also in the auto industry, let me add to the last comments.

Mr. Greenspan implies that——

Mr. Guarini. Please speak up, Mr. Beckman.

Mr. Beckman. Mr. Greenspan implies that, in fact, import substitution does go on by foreign investors, and in the auto industry it has been our experience that import substitution has not occurred. In fact, the vehicles that are assembled in the United States are in addition to vehicles that were already being imported, and as a result the parts that are imported to be assembled into the vehicles assembled here by the Japanese companies are in addition to imports that are already coming in and have been coming in.

So it is our experience that, as Mr. Morris says, the foreign investment has added to U.S. imports in a substantial way and by billions of dollars rather than having a de minimis effect on U.S. trade.

The exports of vehicles by the Japanese companies in the United States have been minimal thus far, and I think it is instructive when you have all the proposals or the dreams of how many vehicles the Japanese companies that produce in the United States are going to export, you have to keep in mind how many cars they import.

So the 100,000 or 150,000 exports have to be balanced against over 2 million imports. You don't see very much balance there.

Mr. Rosenblatt. Mr. Levin, if I may address your question.

You have really asked a very fundamental question about the role of foreign investment in the United States, and I would like to focus on many aspects of this role.

The comments that Mr. Greenspan made indicated that in terms of performance, when you look at the behavior of foreign investors in this country, they do behave very much like an American firm here because they have every incentive to succeed.

Their level of wages are comparable, if not above those paid by U.S. firms, R&D, as I mentioned, is equal to that of U.S. firms.

On the question of trade, they are damned many times because on the surface they do seem to be importing, indeed they are importing a lot more than they export. There is no question about that. However, you have to look at that data a lot more closely.

For one thing, much of the trade is conducted by firms that are classified in the wholesale industry, and these imports by and large would be coming into the United States independent of the foreign investment transactions themselves.

I am not going to say dollar for dollar, but a good deal of it would be coming in from overseas, even if the overseas firm did not have a foreign presence here, so that is one point of looking at it.

The other is when you look at the manufacturing sector of U.S. affiliates, you see that of the imports that they are bringing in, they are not importing much more, relatively speaking, than the overall U.S. economy is importing manufactured goods, and second, they are beginning to add a lot more value-added to the imports that come into this country than they had historically.

So what you are seeing is more of a series of benefits and a convergence in the behavior of foreign firms as compared with those of U.S.-owned firms.

Mr. Guarini. May I interject at this moment.

We have just been joined by the former chairman of the U.S. International Trade Commission, Susan Liebeler.

I understand that you had difficulty getting here this morning through the Washington traffic.

We welcome you and would very much appreciate your remarks at this time.

STATEMENT OF SUSAN W. LIEBELER, IRELL & MANELLA, WASHINGTON, DC (FORMER CHAIRMAN, U.S. INTERNATIONAL TRADE COMMISSION)

Ms. Liebeler. Thank you very much, Mr. Chairman.

I have submitted a formal statement, which I would like to be included in the record.

Mr. Guarini. It will be placed in the record.

Ms. Liebeler. I appreciate this opportunity to address the committee. Today there is growing public concern with the amount of foreign direct investment in the United States, particularly that held by Japanese investors. Some of the most notable recent transactions have been acquisitions of such well-known U.S. entities as Rockefeller Center and Columbia Pictures.

While these transactions have been highly visible, the actual causes and effects of foreign investment are much harder to discern. I think the task is made even more difficult by the flood of books and articles about foreign investment in the United States, many of which rely heavily on anecdotal evidence.

Indeed, the critics of foreign investment worry that foreign investors are buying the very soul of America. Many of the claims about foreign control of the U.S. economy are highly exaggerated.

Foreign investment in the United States accounts for less than 6 percent of total assets and 1 percent of land. Moreover, it is United Kingdom investors and not Japanese investors that hold the largest share.

Nonetheless, it is clear that by whatever measure you calculate the extent of FDI in the United States, it is growing. The most popular explanation for the increase, that it is the result of the large current account deficits of the early 1980's, is not supported by the facts.

The roots of the increase in foreign-direct investment reach back into the early 1970's when the United States was enjoying current account surpluses. A more satisfactory explanation for its growth recognizes that FDI, unlike portfolio investment, provides foreign investors with the ability to exercise control over specific assets.

When a foreign firm has an advantage in technology or management, control of the production process will enable it to produce more efficiently than its U.S. competitors. I think this explanation accords with changes in the world economic system after World War II.

Going back to 1950, when much of the industrialized world was recovering from the devastation of the war, the United States accounted for 40 percent of world gross domestic product, and U.S. firms had consistently better technology and managerial knowhow. Consequently, we saw little foreign investment in the United States and a lot of U.S. investment abroad.

The U.S. position in the world economy in 1950 was unusual and could not have continued. With substantial encouragement of the United States and United States investment abroad, the countries of Asia and Europe built their war-torn economies and have become more like us.

Although U.S. technology and practice are often the best, foreign technology and practices are good and occasionally they are better. Thus, we see the level of foreign investment in our economy approaching that in other industrialized nations.

My message is that foreign investment is not a threat but a vital and beneficial component of our economy. U.S. affiliates of foreign firms provide more than 3 million jobs. They account for 8 percent of U.S. spending on plant and equipment. They account for 21 percent of exports. These affiliates spend $6 billion a year on research and development and they pay $9 billion annually in Federal income taxes.

Foreign investment provides a number of benefits we can ill-afford to forego. It is a source of capital. It tends to increase competition to the benefit of consumers. It influences the domestic economy with new technology and managerial skills.

Critics of foreign investment have identified purported negative effects and in my formal statement I discuss the problems with their criticisms. Inhibiting foreign investment would reduce competitiveness and shrink the size of the pie. Interest rates would go up, the cost of capital will increase and over time this would mean that U.S. output and real wages would grow more slowly.

The value of the dollar would go down, and consumers would be hurt by having to pay more for imported services and goods.

Moreover, our trading partners could retaliate by erecting barriers to U.S. investment. Yet we still see those arguing there is some sinister in growing foreign investment, and they call for additional regulation.

We do not need additional regulation of foreign investment. We have ample laws and regulations in place to monitor and analyze inward foreign investment and to safeguard national security. The benefits of FDI are too important and the costs of inhibiting it too dear.

The United States should remain committed to an open foreign investment policy. Yes, there has been an increase in foreign investment in the United States, and it is not surprising. Foreign interests have more money and improved technology and managerial know-how. The United States is also a very good place to invest, and it is in the national interest to keep it that way.

Thank you very much, Mr. Chairman, for the opportunity to testify. I would be happy to answer any questions.

[The statement of Ms. Liebeler follows:]

IRELL & MANELLA
A LAW PARTNERSHIP INCLUDING PROFESSIONAL CORPORATIONS

STATEMENT of SUSAN W. LIEBELER
on
FOREIGN INVESTMENT IN THE UNITED STATES

I. Introduction

Good afternoon, Mr. Chairman and members of the Committee. My name is Susan Liebeler and I am a partner in the law firm of Irell & Manella, resident in the Washington, D.C. office. As a former chairman of the U.S. International Trade Commission, I appreciate the opportunity to express my views on the causes and effects of foreign investment in the United States.

Foreign investment is currently the subject of considerable public debate. Indeed, in the last few years, there has been such a flood of literature on foreign investment that perhaps the Commerce Department should begin to keep statistics on the number of Americans making their living by writing and talking about foreign investment.

The vast majority of these works are critical of foreign investment. There have been fewer works in defense of foreign investment. However, much of the literature on both sides of the debate suffers from the same faults. The authors tend to rely heavily on anecdotes at the expense of a systematic treatment of the issues and an analysis of the relevant data.[1]

As total foreign investment in the United States grew from $174.5 billion in 1973 to $1.786 trillion in 1988,[2] it has been subjected to considerable public scrutiny. The focus of the debate has not been on portfolio investment but on foreign direct investment ("FDI"),[3] a relatively small portion of total inward foreign investment.[3] As of the end of 1988, FDI totalled $328.9 billion, growing from $20.6 billion in 1973.[4] FDI accounts for less than 6 percent of all U.S. assets[5] and less than 1 percent of all U.S. land.[6]

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[1] A notable exception is E. Graham & P. Krugman, Foreign Direct Investment in the United States (1989) (hereinafter "Graham & Krugman"). The book is an excellent analysis of the issues raised in the debate surrounding foreign investment, and it develops a great deal of new data on the subject. I cite frequently to this book in my testimony.

[2] U.S. Department of Commerce, 69 Survey of Current Business 43 (June 1989) (hereinafter Commerce Survey).

[3] The Bureau of Economic Affairs ("BEA") of the U.S. Department of Commerce, which collects data on foreign investment, classifies foreign investment as FDI when a single foreign entity holds at least a 10 percent equity interest in a U.S. business or real estate. Foreign portfolio investment includes everything else, such as bank deposits, government securities, corporate bonds and noncontrolling interests in corporate stock.

[4] Commerce Survey, supra note 2, at 43. About one-third of FDI is in manufacturing, about one-fifth is in wholesale and retail trade and about one-tenth is in each of petroleum and real estate. Testimony of Michael R. Darby, Under Secretary of Commerce for Economic Affairs, before the Senate Committee on Commerce, Science and Transportation 5 (July 11, 1989).

[5] W. MacReynolds, "Facts and Fallacies about Foreign Investment," U.S. Chamber of Commerce Policy Working Papers 2 (June 1988).

[6] Graham & Krugman, supra note 1, at 23.

The crucial distinction between FDI and portfolio investment is control over the property. In contrast to FDI, a portfolio investment involves the establishment of an interest in an asset without the ability to control the asset.

There is no question but that the growth of FDI has had an emotional impact on many Americans. For example, the acquisitions of Rockefeller Center and Columbia Pictures have caused some to worry that foreign investors are buying America's soul. While such transactions are highly visible, the extent of foreign investment is not as large as one might believe.

II. Growth of FDI

There are a number of ways to measure FDI,[7] but regardless of which is used, FDI has grown steadily since the early 1970's. There have also been two surges: the first occurred between 1977 and 1981; we are in the midst of the second, which began in late 1986.[8] Nevertheless, the level of FDI in the United States is well below the level in the other industrialized economies.

The most widely used measure of FDI is its historical cost. The ratio of the book value of FDI to the book value of all nonfinancial corporations quadrupled from 2.1 percent in 1977 to 8.9 percent at the end of 1988. Another measure of FDI, the assets of foreign manufacturing affiliates as a percentage of assets of U.S. manufacturing firms more than doubled from 1977 to 1987, rising from 5.2 percent to 12.2 percent. Another way of measuring the extent of the foreign presence in the U.S. economy is to look at employment by foreign affiliates. Foreign affiliates' share of U.S. employment increased from 1.7 percent in 1977 to 3.5 percent in 1987, and their share of manufacturing employment increased from 3.5 percent to 7.9 percent. Over the same period, foreign affiliates' share of GNP and value added in manufacturing rose from 1.7 percent to 3.4 percent and from 3.7 percent to 8.3 percent.[9]

Foreign direct investment in the United States is still below the level of FDI in most other advanced economies, where FDI in percentage terms is around the same level as it was a decade earlier: in 1986, foreign-owned firms accounted for 17 percent of assets and 13 percent of manufacturing employment in West Germany and 14 percent of both assets and manufacturing employment in the United Kingdom.[10] In effect, the U.S. business landscape is developing the same mix of domestic and foreign firms that is present in the rest of the Western world.[11]

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[7] Each method illuminates different aspects of foreign influence in the U.S. economy resulting from FDI. None of these methods are perfect; they all suffer from problems which can cause the foreign role to be exaggerated or underestimated, depending on which method is used.

[8] Graham & Krugman, supra note 1, at 2-3.

[9] Graham & Krugman, supra note 1, Table 1.2, at 13.

[10] Graham & Krugman, supra note 1, Table 1.8 at 25 (citing data from D. Julius and S. Thomson, Foreign-owned Firms, Trade, and Economic Integration (Tokyo Club Papers 1988)).

[11] Japan is the exception to this trend, as it continues to have a very low level of FDI. Foreign-owned firms account for only around 1 percent of assets and employment in Japan. The evidence does not suggest that this difference is a result of Japanese restrictions on FDI, however. Although Japan has legal machinery that permits screening of FDI, there is little actual screening of FDI except in defense-related industries. The difficulty that

III. The Causes of the Growth of FDI

Two less than persuasive explanations are commonly offered for the growth of FDI in the United States. The first is that the growth of FDI is a result of the massive U.S. current account deficits that surfaced in the 1980's. In support of this view, proponents usually point to the large increases in foreign debt that occurred in the 1980's and corresponding large increases in FDI over the same period. The argument that the growth of FDI is a result of U.S. current account deficits is, however, not supported by the facts. The growth in FDI in the United States began in the early 1970's, when the United States frequently had a current account surplus, and surged in the late 1970's leveling off in the early 1980's before the huge deficits began.[12]

Another argument offered to explain the growth of FDI is based on the cost of capital. According to this argument, foreign investors are able to outbid U.S. investors for U.S. assets because they enjoy lower interest rates.[13] Again, the facts do not support the argument. If a low cost of foreign capital were the prime cause of FDI, one would expect very little local financing because foreign financing would be cheaper. Yet U.S. affiliates of foreign firms rely heavily on local financing for their operations.[14]

A better explanation for the growth of FDI recognizes that FDI provides foreign investors with the ability to exercise control over assets, which a portfolio investment does not. A foreign investor that wants to produce, say television sets, in the United States will make a direct investment, either by building a new plant or buying an existing one. When the foreign investor has a technological or management skills advantage in the production of television sets, control of the production process enables it to produce more efficiently than its domestic competitors.

This view is supported by the history of the U.S. color television industry, which is now largely foreign-owned. Although there is only one U.S.-owned producer, Zenith, and most of its production is in Mexico, there are more than 20 U.S. affiliates of foreign firms producing color televisions sets in the United States. Together, these companies produce almost 70 percent of all color television sets sold in the United States,

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U.S. and other non-Japanese firms often experience in penetrating the Japanese market likely are a result of cultural and structural factors.

[12] Graham & Krugman, supra note 1, at 10-16. The nationality of the ownership of FDI also undercuts international capital flows as an explanation for the pattern of FDI. As of the end of 1988, the United Kingdom had the largest stock of FDI in the United States, with a book value of $101.9 billion. From 1980 through 1988 the United Kingdom was the largest source of new FDI, yet the United Kingdom has not been running current account surpluses corresponding to U.S. current account deficits. See Graham & Krugman, supra note 1, at 33-34.

[13] A lower foreign interest rate means that foreign investors discount future cash flows by smaller amounts than do domestic investors, making any stream of payments worth more in foreign hands than in U.S. hands.

[14] According to preliminary BEA data for 1986, over 80 percent of the debt and current liabilities of U.S. affiliates is financed in the United States by U.S. persons. Graham & Krugman, supra note 1, Table 1.1 at 11. This suggests that at the margin, foreign financing is no cheaper than U.S. financing.

with about 40 percent of the value-added being domestic.[15] What happened to the traditional U.S. producers is straight forward. In the mid-1970's, foreign producers developed a better design and production system than their U.S. rivals. After U.S. firms received protection from imports, foreign firms established operations in the United States where they produced sets that had fewer parts than their U.S. counterparts. Technological innovations in design and production techniques gave the foreign companies a competitive advantage, and, as a result, foreign-owned firms dominate the U.S. television industry.

Historical investment patterns are consistent with the foregoing explanation. The United States' position as the preeminent economic power immediately after World War II was unusual and could not be expected to remain indefinitely. Economic output in 1946 was well below its prewar level in France, West Germany, Italy and Japan. As late as 1950, output in West Germany and Japan had not returned to prewar levels.[16] In 1950, U.S. output was two-thirds larger than its prewar level,[17] and the United States accounted for 40 percent of the world's gross domestic product ("GDP").[18] At that time, Japan accounted for less than 2 percent of world GDP and Europe accounted for about 20 percent.[19] U.S. firms had better technology and better managerial know-how, and the United States had a large trade surplus in high-technology products. As a result, there were few foreign firms able to compete in the United States, whereas there were many U.S. firms able to compete abroad. The result was that there was little FDI in the United States and a lot of U.S. investment abroad.

The world, however, has changed since 1950. The countries of Europe and Asia have long since rebuilt their war-torn economies, in significant part with the aid and encouragement of the United States and U.S. investment abroad. The United States is still the world's leading economic power although its dominance and preeminence have declined. Between 1950 and 1973, the capital-labor ratio in other major industrialized nations grew one-and-one-half times as fast as the U.S. ratio, and their productivity grew twice as fast.[20] The other nations were able to raise their productivity by investing in capital that embodied the latest U.S. technology. Although this investment sometimes required modification of U.S. technologies, that was often quicker and less expensive than developing new technologies.[21] By 1980, Japan accounted for 9 percent of the world's GDP, Europe 30 percent, and the United States 22 percent.[22]

There was bound to be a closing of the gap, and U.S. government policy was to hasten this process. This it accomplished not by restraining advancement at home (in fact,

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[15] Thomas Gale Moore, The Promise of High-Definition Television: The Hype and the Reality 9 (1989) (citing data from Nathan Associates).

[16] Economic Report of the President 1989 148.

[17] Id.

[18] J. Bhagwati, Protectionism 67 (1989). Bhagwati credits a 1983 study by the United Nations Conference on Trade and Development as the source for the statistics.

[19] Id.

[20] Economic Report of the President 1989 31.

[21] Id.

[22] J. Bhagwati, Protectionism 67 (1989).

U.S. postwar growth exceeded U.S. prewar growth),[23] but by encouraging growth abroad. As a result, foreign growth rates among advanced economies generally exceeded U.S. growth rates in the postwar period, and U.S. investment and technology played a large role in this growth.[24] The U.S. still produces and exports a lot of high technology products, and high-technology products account for an increasing share of U.S. exports.[25] There are, however, many areas in which foreign firms have superior technology or management skills that allow them to compete in the United States. The net result is a rise in FDI in the United States.

Now that other countries have reached a level of technological development similar to the United States', foreign participation in the U.S. economy is approaching the level found in other industrialized countries. There is, however, no reason to expect that the level of FDI in the U.S. economy will ultimately exceed the level of FDI present in other industrialized economies.

IV. The Effects of FDI

Much of the public debate on FDI has emphasized the purported deleterious effects of FDI on the domestic economy, and, in particular, the fear that the United States is about to lose control of its economic destiny. This fear, however, is premised on the faulty arguments of dependency: that FDI costs jobs, which are performed abroad; that FDI transfers the good jobs abroad; that FDI will increase the trade deficit as foreign affiliates import their materials from abroad; and that U.S. technology will suffer as research and development is conducted abroad.

The loss of employment argument rests on the supposed tendency of U.S. affiliates to source offshore which reduces the demand for domestic goods and services.[26] On the other side, the proponents of FDI point to the creation of jobs associated with FDI, and claim that many of these jobs would not otherwise exist.

These arguments are both wrong: the net effect of FDI on U.S. employment is approximately zero. This is not to say that FDI cannot have an effect on unemployment in specific industries or regions; it certainly can and these effects can be very important. The point is that the net effect of FDI on aggregate U.S. employment is essentially zero, and this is true regardless of the gains and losses across industries and regions. It is widely accepted by economists that aggregate unemployment in the U.S. economy cannot be driven below about 5 or 6 percent without causing an upward inflationary spiral. Similarly, when demand for goods and services falls, raising the prospect of increased unemployment, the Federal Reserve can stimulate demand and employment by cutting interest rates. Thus, aggregate unemployment in the economy is determined not by demand but by structural conditions in the labor market that prevent the

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[23] Economic Report of the President 1989 30.

[24] See Economic Report of the President 1989 Table 4-1 at 150.

[25] Economic Report of the President 1989 236.

[26] Sometimes the advocates of this view attempt to estimate how much greater U.S. employment, say, in the steel industry would be if the U.S. affiliates of the Japanese automakers used as much U.S. steel as the U.S. automakers. This is done for each industry and the totals are summed to arrive at a total number of jobs lost.

Federal Reserve from reducing employment below 5 or 6 percent.[27]

The quality of employment argument is similarly flawed. Some commentators have claimed that FDI will lead to a fall in the number of good jobs in the United States, a claim premised on the notion that foreign firms will keep the high-paying jobs at home. This assertion, however, is not borne out by the facts. Wages and value added per worker in manufacturing are roughly comparable for U.S. affiliates and domestic firms, undercutting the claim that foreign firms keep the good jobs and high-value production at home.

Critics also argue that FDI increases the trade deficit. The argument is again premised on the supposed tendency of U.S. affiliates to source offshore, which, it is asserted, will have the effect of worsening the trade deficit and lead to a reduction in the value of the dollar. Although there is some evidence that U.S. affiliates have a higher propensity to import than do domestic firms, this does not necessarily mean that FDI tends to increase the demand for imports. To the extent that FDI displaces imports and increases exports, FDI tends to reduce the trade deficit. According to Graham and Krugman, even under the most pessimistic assumptions, the effect of any higher propensity among foreign affiliates to import is small.[28]

In the area of imports, however, there is a major difference between U.S. affiliates of Japanese companies and other foreign manufacturing firms. Affiliates of Japanese firms use 2.5 times as much imports per worker as affiliates of other foreign firms.[29] Some of this can be explained by data problems. For example, some affiliates of Japanese firms that are classified as manufacturing firms are largely retailing firms, which can be expected to have a high propensity to import. Another reason for the high level of imports is that Japanese FDI is much newer than European FDI. When a new firm begins producing in a foreign market it uses a lot of imported articles. Over time, as the affiliate gains experience in the local market, it tends to increase its local content and reduce its reliance on imported inputs.

For example, when Honda and Nissan began assembling cars in the United States they had 30 and 47 percent domestic content. In 1987, Honda and Nissan reported local content of 60 and 63 percent, and they expect to have local content of around 75 percent by the early 1990's.[30] Thus, in light of the relative youth of Japanese FDI, it is too early to conclude that U.S. affiliates of Japanese firms will have a higher long-run propensity to import than other U.S. affiliates.

Another criticism is that FDI will reduce the level of research and development in the United States. Research and development, the argument goes, produces important spillover effects. It is asserted that there is a tendency for multinational corporations to keep their research and development close to their headquarters, so that when a foreign firm acquires a U.S. firm it will conduct research and development activities offshore, depriving U.S. residents of the opportunity to take advantage of spillovers. The claim that there is a tendency for foreign firms to conduct research and development primarily at home is not supported by the data. A comparison of research and development per worker in manufacturing yields roughly comparable numbers for U.S. firms and U.S. affiliates of foreign firms.[31]

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[27] See Graham & Krugman, supra note 1, at 48-49.

[28] Graham & Krugman, supra note 1, at 57-58.

[29] Graham & Krugman, supra note 1, at 60.

[30] Graham & Krugman, supra note 1, 61-62.

V. The Benefits of Foreign Investment

Historically, foreign investment played an important role in helping to build the United States, and it is providing investment capital today. Foreign direct investment builds plants, employs U.S. workers, and promotes the transfer of foreign technology and management practices to the United States. U.S. affiliates of foreign firms provide over 3 million jobs and have an annual payroll over $90 billion; they account for about 8 percent of U.S. spending on plant and equipment and 21 percent of U.S. exports; and they spend $6 billion a year on research and development and pay $9 billion in federal income taxes annually.[32]

FDI increases the benefits from trade by facilitating trade in goods, services and technology. FDI encourages the specialization of production, permitting firms to achieve a larger and more efficient scale of production. FDI also tends to increase competition to the benefit of the consumer.

FDI is an important source of capital to the United States. If FDI were restricted, much of this capital would be lost, at least to the extent it is not redirected into portfolio investment. The loss of these funds would result in a fall in the value of the dollar and increases in U.S. interest rates. The former would make the United States poorer by increasing the price of imported goods and services. And increasing U.S. interest rates would harm U.S. competitiveness by restricting the funds necessary for expanding economic growth.

FDI also provides "spin off" benefits to the domestic economy in the form of technology and managerial skills. These external benefits are manifested in the training received by U.S. workers that can be transferred to other jobs; new managerial techniques employed by executives of U.S. affiliates that can be shared with their counterparts at domestic firms; and new technologies that will find their way to other parts of the U.S. economy.

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[31] Graham & Krugman, supra note 1, at 58-59.

[32] Michael Darby, "Remarks on Foreign Investment and the State of the Economy" 6 (speech given Sept. 21, 1989 at San Diego) (citing preliminary BEA results for 1987); Graham & Krugman, supra note 1, at 46 (1986 export percentage); John Robinson, "U.S. Policy on Foreign Investment," (speech given Oct. 12, 1989 in Tokyo) (1987 statistics), reprinted in 1 Foreign Investment in the U.S., News & Analysis, 19 (BNA Nov. 1989).

VI. Existing Regulation of Foreign Investment

Given the benefits we derive from FDI, we must be careful not to adopt regulations that unnecessarily discourage foreign investment. While U.S. markets are generally open to participation by persons without regard to their nationality, there are a number of existing restrictions that apply specifically to foreign investment. For our purposes, these laws and regulations may be classified into two main categories: those that prohibit or limit foreign participation--laws that were, for the most part, motivated by national security concerns --and those that require disclosures to (and in some instances, approval from) U.S. government agencies.

There are a number of federal laws designed to safeguard national security that impose significant constraints on the transfer of technology and the export of sensitive goods. For example, the Exon-Florio Amendment to the Defense Production Act of 1950 gives the President the authority to block foreign acquisitions of U.S. businesses that might threaten to impair U.S. national security.[33] Under the International Emergency Economic Powers Act,[34] the President can take a wide range of actions if there is an unusual and extraordinary threat to national security, foreign policy or the U.S. economy from foreign sources. The Act was used, for example, to freeze Iranian assets in the United States during the Iranian hostage crisis, to curtail trade with Nicaragua and Libya, and to block transfers of U.S. funds to Panama.

The Department of Defense has comprehensive regulations promulgated pursuant to the Defense Industrial Security Program covering the performance of government contracts that involve classified information.[35] In general, a contractor must not only obtain a clearance for itself, but each employee with access to classified information as well as the contractor's principal officers and executive personnel must be individually cleared. These clearances are not generally available to foreign nationals. Contractors found to be under foreign ownership, control or influence cannot obtain the necessary security clearances.[36]

The International Traffic in Arms Regulations[37] and the Export Administration Act[38] and regulations impose significant restrictions on foreign direct investment in the United States. These regulations require an exporter of defense and high-technology articles and classified information to obtain government approval, which, in some instances, can only be giver to U.S. persons. Moreover, exports requiring government approval are broadly defined to include the disclosure of "technical data" to a foreign person, an event that can be deemed to occur when a foreign person makes a direct investment in a U.S. business entity. The necessary approval for this "export" may be difficult or impossible to obtain, depending upon the sensitivity and degree of sophistication of the technical data and the nationality of the foreign investor.

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[33] To be codified at 50 U.S.C. App. § 2170. Exon-Florio is administered by the Committee on Foreign Investment in the United States ("CFIUS"), which is composed of the Secretaries of Commerce, State, and Defense, the Attorney General, the United States Trade Representative, the Chairman of the Council of Economic Advisors, the director of the Office of Management and Budget and the Secretary of Treasury, who serves as its chairman.

[34] 50 U.S.C. §§ 1701-1706.

[35] This consists of two sets of regulations: the Industrial Security Regulation, DOD 5220.22-R (Dec. 1985), and the Industrial Security Manual for Safeguarding Classified Information, DOD 5220.22-M (Sept. 1987).

[36] However, a foreign investor may be able to obtain the necessary clearances by taking steps to insulate the contractor from its control and influence.

[37] 22 C.F.R. §§ 120.1 - 130.17 (1989).

[38] 50 U.S.C. App. §§ 2401-2420 (1982).

National security concerns are responsible, at least in part, for the restrictions imposed on foreign investment in certain regulated industries. Broadcasting licenses may not be awarded to a foreign person or corporation, and foreign investment in a U.S. entity that holds a broadcasting license is restricted. The domestic airline and maritime shipping industries are also regulated in approximately the same manner. Understandably, a foreign-controlled entity cannot engage in the development of nuclear power. Moreover, there are a number of miscellaneous restrictions on the development of natural resources on federally-owned lands by foreign persons.

Several provisions in U.S. law explicitly require the disclosure of foreign investments to the federal government. Perhaps the best-known is the International Investment and Trade in Services Act,[39] a comprehensive reporting statute designed to track foreign investment within the United States (as well as U.S. investment abroad). In addition, under Exon-Florio, foreign investors provide CFIUS with information about proposed acquisitions of U.S. businesses with potential national security implications. Foreign investors must also report certain investments in U.S. agricultural land to the Secretary of Agriculture,[40] and foreign corporations doing business in the United States and their U.S. affiliates must file annual reports with the Internal Revenue Service concerning specified transactions with related parties.[41] Moreover, foreign investors are subject to the extensive disclosure requirements contained in the U.S. securities and antitrust laws that apply to all investors.

As this brief survey indicates, there are several laws and regulations that adequately safeguard our national security and permit the Government to monitor and analyze foreign direct investment. Additional regulation is unnecessary and could be counterproductive. Additional regulation that has the effect of discouraging foreign investment would raise the cost of capital and reduce investment in the United States. Over time, this would cause U.S. output and real wages to grow more slowly, reduce U.S. competitiveness and might lead to the erection of barriers to U.S. investment abroad. Moreover, U.S. interest rates would rise and the value of the dollar would fall, thereby increasing the cost of foreign goods and services to U.S. consumers.

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[39] 22 U.S.C. §§ 3101-3108 (1982 & Supp. 1987).

[40] 7 U.S.C. §§ 3501-3508 (1988).

[41] 26 U.S.C. § 6038A(a), as amended by H.R. 3299 121 Cong. Rec. H-5812 (Daily ed. Sept. 20, 1989).

VII. Conclusion

Much of the rise in FDI reflects natural economic developments and the success of U.S. foreign policy in the postwar era. FDI occurs because foreign firms have technology and management skills that allow them to compete successfully in the United States. As U.S. economic preeminence has declined, more foreign firms have become competitive with domestic firms on American soil.

Although the rise of FDI in the United States is indicative of the relative decline in U.S. economic preeminence, rising FDI is not a cause of that decline. It is an effect, not a cause.

Declining superiority should be addressed directly, not by restricting foreign investment. If our country is to maintain a technological advantage--or even to keep pace with the technological developments that are in large part responsible for the growth in FDI--it must invest in research and development, plants and equipment, and the educational resources that maintain and advance technology.

Yes, there has been an increase in foreign direct investment in the United States and it is not surprising. Foreign interests have more money to invest, improved technology and managerial know-how, and the United States is a very good place to invest. It is in the national interest to keep it that way.

Thank you very much, Mr. Chairman, for the opportunity to testify. I will be pleased to answer any questions.

Mr. GUARINI. Thank you very much, Ms. Liebeler. Is there any point, Ms. Liebeler, that you would be concerned as to the extent of foreign investment in the United States? Do you feel that the more the better or do we have a bell curve? Is there a point that we are concerned about our economic sovereignty or concerned about involvement in our political process? Is there a point at which people outside the United States would have too much to say in how we shape the laws in our country and at which their influence would become very strong and noticeable?

I know American pride is out there, but should we become concerned at a particular level or is such influence so minuscule that we don't even have to talk about it at this point?

Ms. LIEBELER. The existing level of foreign-direct investment is nowhere near the level you seem to be describing, where you could be concerned about our sovereignty. The discussion in the media and by commentators generally about the political influence of foreign companies investing in the United States suggests that when foreign firms hire former U.S. Government officials or lobbyists, it is somehow adverse to the interests of the United States.

Special interests, as I am sure the committee is all too well aware, are the life blood of our political system, and perhaps more competition among special interests would be a good thing. For example, you will often see domestic firms seeking import protection in the form of tariffs, quotas, or voluntary restraint agreements.

It is not at all clear that the use of these firms' political influence to obtain protection from import competition is good for the United States as a whole. To the extent that foreign interests are lobbying in favor of the importation of low-price, high-quality goods, they tend to balance each other and perhaps discourage adoption of some policies that would have ill-effects.

Mr. GUARINI. I guess there is concern about the Japanese car more than goods from Holland or England or Germany because our trade deficit with Japan is $50 billion. Their banks have become so strong and powerful, and there appears no prospect of that being abated. They are coming on stronger all the time.

The question is: Is there a point at which we would think it important to track what is happening in our country? As I understand it, there is a great reluctance to track what the foreign investments are in the United States, so legislation seems to fail.

It passed the House twice but didn't go beyond that, and then on investments we withdrew withholding taxes so that we don't disturb the flow of money coming inside the country on bonds, to pick up the shortage on our deficit.

Do you become, Dr. Rosenblatt, concerned about the direction that the charts are going or do you think that the more the better and that this is just a part of the new look of the global stage that we are on?

Mr. ROSENBLATT. Let me start with the bottom line there. What I think would be the most desirable policy for the United States to pursue is to once again get its own house in order so that we can become a net creditor nation to the world at large.

Mr. GUARINI. I think everybody agrees with you. The question is how.

Mr. ROSENBLATT. We are the largest industrial economy. We should be a net lender to the world and not a net absorber of capital. So I think that is where my bottom line is. In terms of concern, I think that we need to recommend that there are benefits to the U.S. economy from direct investment and portfolio investment, which have been elaborated this morning, and I won't go into those again. But second we already have in place a large body of law that will protect U.S. vital interests if, indeed, for some reason some investments do threaten the national security.

The Exon-Florio amendment to the 1988 Omnibus Trade and Competitiveness Act which we are now in the process of implementing is one example of that in the national security area. We have in place the kinds of restrictions that we need if foreigners begin to act or behave in an anticompetitive way, we have antitrust laws to deal with them just as we would with a U.S. firm.

Mr. GUARINI. We are not really as worried about national security in terms of events in the world as we used to be.

Mr. ROSENBLATT. I am trying to put this in perspective in terms of your concern. You raised a very fundamental issue, which borders on the question of the emotional content of this question, which is very high, as you know.

I want to talk about your questions on tracking the data because that has come up repeatedly, and it is a very important issue, and AFII has opposed Mr. Bryant's attempt to pass H.R. 5 because for a number of reasons.

AFII starts with the proposition that the Federal Government should have all the data that it needs to deal with foreign investment as a policy issue. Our basic and fundamental problem with Mr. Bryant's amendment or proposal is its disclosure aspects. We don't see any benefit in running the risk of having individual business confidential information exposed to potential competitors as possibly could happen under the proposal that Mr. Bryant has put forward.

Mr. GUARINI. Couldn't that throw some of our money offshore where our own people might be able to take advantage of that lack of reporting?

Mr. ROSENBLATT. Well there is reporting now that is required of foreign investors, just as there is of the U.S. firms. The International Trade and Services Survey Act of 1976 which established the system which we now have and on which all of the discussion today in terms of data and shares and what have you are based is in place, and we do collect information.

So it is the disclosure, the individual disclosure aspects that we do not like. We are also on record as supporting proposals to improve the data system of the United States. Senator Murkowski had introduced a bill last session which talked about promoting compromise and better working relationship between BEA and the Census Bureau.

We heartily support this because it would provide a data base that is more disaggregated than the one we presently have. It would do so without imposing added reporting requirements on anyone. It would not run the risk of disclosure of any individual business information, so we favor this kind of approach to improving the data.

Mr. GUARINI. How do Mr. Morris and Mr. Beckman feel about tracking and disclosure?

Mr. MORRIS. Well, we have said repeatedly that we feel that it ought to be done, certainly as far as our own industry is concerned. Moreover, we believe an apparatus should be in place to provide for more disclosure of transplant assemblers purchases of U.S. auto parts.

We are at a loss to understand why the Japanese Government would resist this or rather the Japanese carmakers specifically. It seems to us that whether good or bad, it would strengthen their case to be as forthcoming as possible with this data. It would not endanger competitive information at all in this instance.

Mr. GUARINI. Mr. Beckman.

Mr. BECKMAN. Thank you. This gives me an opportunity to address an issue that Mr. Rosenblatt raised earlier, which is that a lot of the imports show up in the wholesale trade category in the data that is currently collected. One of the reasons for that is that the Japanese car companies, until the early 1980's, were distributors of cars in this country and their investments were therefore counted in the category of wholesale trade.

Because those individual companies have been pigeon-holed in that category, additional investments have also been pigeon-holed in that category. Therefore a lot of what is included in that particular grouping and the data that is available is, in fact, automobile manufacturing investment, and the imports related to that, so the data that is currently collected is not adequate, certainly in addressing what is going on in the auto industry.

It just does not reflect the reality. So that is one issue in tracking that is important. If disclosure were in fact the only or the major reservation of foreign investors and U.S. multinational corporations, I would think that there would be a whole lot more cooperation with Congressman Bryant and others interested in developing an appropriate mechanism for tracking foreign investment rather than the rather impressive opposition and all out attack on the approach to collecting information as an impediment to foreign investment.

I think the disclosure problem could quite simply be worked out. Congressman Bryant has not stated that the dissemination of business confidential information is one of the important elements of this legislation. I think that is a red herring.

I think the fact is that the companies, the foreign companies, and U.S. companies that have foreign interests, do not want the United States to do anything, to move anywhere on the issue of foreign investment because they think it jeopardizes their current free rein to invest here and wherever else they want and to negotiate with foreign governments over their foreign investments.

The notion that foreign governments will retaliate if the United States collects information or in some way charts or tries to exercise some guidance to foreign investment is just absurd given what other countries already do. No other country has the system we have. Every developed country at least collects data that they find useful, and the government has determined what data is appropriate. Most countries, most developed countries and certainly developing countries, engage in quite specific negotiations with individnal foreign investors regarding what they are going to do for that country.

We have pushed this policy of opening markets for foreign investors for 40 years, 50 years. What have we gotten? Other countries are still doing what they think is in their national self-interest, and if it hasn't been successful for the last 50 years, I don't see any reason why we should have any expectation that it is going to be successful in the next 2.

Mr. GUARINI. I guess the argument is if there is no withholding tax, no tracking of investments, that it makes our bonds more attractive to them. It probably keeps interest rates up, it makes it more attractive because they don't have to pay income tax on it, and there is no way we ever have of knowing, so therefore the person who is working in the steel mill in Youngstown, OH, subsidizes these people who are able to take advantage and walk away from our tax system with impunity.

That is, of course, the argument, and it all depends what industry you are in and where you come from as to how you answer this. Ms. Liebeler, I noticed you were taking certain notes. I am going to conclude at this time. Is there anything you want to say in conclusion?

Ms. LIEBELER. In terms of some of the problems with the data base and the kinds of information the Commerce Department collects, many of the inconsistencies and problems that have been raised in these hearings can be fixed without legislation.

There is a recent study in Great Britain that suggests that the U.S. data base on foreign investment is among the better information sources in foreign investment in the world. I do not believe that legislation is necessary to fix the data base, and I understand this to be the administration's position as well.

For the most part the Department of Commerce provides very useful information, and I don't think legislation is the way to address the data consistency problems or the kind of classification problems that have just been raised by Mr. Beckman.

Mr. CARDIN. Can I followup on that point?

Mr. GUARINI. Yes, Mr. Cardin.

Mr. CARDIN. If legislation is not needed and you have acknowledged there is a need for improving the data base, why is the administration not taking steps to collect the data necessary?

Ms. LIEBELER. I am not sure that I would like to take the position that there is a need to improve the data base. I would acknowledge, however, that people have pointed out areas where information is not as complete as it could be. Given the kinds of classification problems which have been raised by Mr. Beckman, the problem may be a budgetary one. It may have to do with the amount of resources available and the issue should perhaps be addressed to Under Secretary Darby.

Mr. CARDIN. I understand the budgetary issues. I thought I understood from your prior comments that there was need for improvement. I guess I misunderstood you.

Ms. LIEBELER. I am sorry. I was referring to the need for improvement that others have identified. I do not want to suggest that I necessarily agree with those needs. Sometimes when people complain about the data, what they really seek is firm-specific information.

I have heard many people complain about the data and their story often goes like this: "We tried to find out what a particular firm in my constituency or in my district was doing and buying, and the Department of Commerce wouldn't give us the data." For these types of complaints, I have no sympathy. I do not think they are legitimate concerns.

Mr. CARDIN. Do you agree with Mr. Beckman that other nations that we are in competition with for capital have more disclosure requirements with Government officials and the like than we do in the United States?

Ms. LIEBELER. I am not sure that I can agree with that. I would have to think about that.

Mr. CARDIN. Do you believe the United States should have similar requirements on disclosure for investors from other countries in which that country requires certain disclosures from American investors?

Ms. LIEBELER. More disclosure is not necessarily beneficial. For example, you could have a disclosure regime in another country that was burdensome and served as a de facto screening process. I would not suggest that we hurt ourselves by adopting that kind of a regulatory system.

You would have to look at the benefits of any particular disclosure regime and see if they outweighed its costs.

Mr. GUARINI. Dr. Rosenblatt.

Mr. ROSENBLATT. I would like to address some of the questions Mr. Cardin raised. One, you ask why doesn't the administration do anything about the data. Indeed, it is. If I may get a little bit technical in an economist's jargon for a moment, the big problem with the existing data base on foreign direct investment is that it is too highly aggregated.

BEA collects information at the enterprise level, which is at three digits, most useful information for economic analysis is at the four-digit level or the establishment level. BEA and the Census Bureau have underway a pilot project to which I alluded earlier and which Senator Murkowski would also achieve through his legislation to share the data at the three-digit and the four-digit level to make this information more available on foreign direct investment so the kinds of issues that Mr. Beckman and I have been having a by-play about can be resolved much more effectively. So there is an effort underway already.

It is important to support that, and we do. We wholeheartedly support that kind of an effort to improve the data base. A couple of other questions you asked. No country that I am aware of has a disclosure requirement similar to that contained in Congressman Bryant's bill, and I would like to second Ms. Liebeler's comment that the United States indeed has among the best data bases on foreign direct investment around the world.

Mr. GUARINI. This concludes the portion of our hearing devoted to the question of foreign investment in the United States. I want to thank all our witnesses for their interesting and informative testimony. It will be of help to this committee in its effort to assess policies in the future and proposals that will be aimed at addressing problems in this area of great concern and great debate throughout our country.

Our next hearing will begin Tuesday, January 30, at 9:30 a.m. in this hearing room. On that day we will receive testimony on the U.S. trade relations with the Soviet Union and Eastern Europe and on Europe 1992.

I wish to thank you all and bid you a good day. The hearing is adjourned.

[Whereupon, at 12:45 p.m., the hearing was adjourned, to reconvene on Tuesday, January 30, 1990, at 9:30 a.m.]

U.S. TRADE RELATIONSHIPS WITH THE SOVIET UNION AND EASTERN EUROPE AND THE IMPLICATIONS OF "EUROPE 1992" ON AMERICAN DIRECT INVESTMENT

TUESDAY, JANUARY 30, 1990

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met, pursuant to call, at 9:30 a.m. in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. We will come to order.

Today the Committee on Ways and Means begins hearings on the issues of United States trade relations with the Soviet Union and Eastern Europe.

These hearings come at a time of unprecedented change in countries of that region with the best proceeding in the direction and at a pace that no one could have predicted just 6 months ago.

I know I reflect the sentiments of my colleagues on this committee when I say that our hopes are with the people of Eastern Europe in their efforts to move toward democratic free market societies.

They stand to gain if their efforts are successful. Our gain will be reflected in the more stable, peaceful relationships that hopefully will emerge in that part of the world. However, we must not underestimate the difficulties that lie ahead for these countries.

If they are to be successful in creating the kind of political and economic systems which they and we want to see, we obviously must be prepared to pull together to help them achieve their goals.

The purpose of these hearings is to assess the current state of our trade and economic relationships with the Soviet Union and Eastern Europe and to hear expert views as to the direction these relationships should take in the future.

The administration has begun a process aimed at granting the most-favored-nation status to the Soviet Union later this year. The administration also appears to be giving serious consideration to beginning such a process with Czechoslovakia.

Negotiators are working on the business and economic agreements with Hungary and Poland, and similar activities with other Eastern European countries cannot be far behind.

Title IV of the Trade Act of 1974, the so-called Jackson-Vanik amendment, is the appropriate law governing U.S.-trade relations with nonmarket economy countries. We will receive testimony tomorrow from one of the authors of that statute, the Honorable Charles Vanik. He and other experts will share their views as to how we should proceed under that law.

A number of questions need to be addressed, including beginning to discuss the possible repeal of Jackson-Vanik in light of the dramatic changes in the Soviet Union and Eastern Europe.

As the committee with primary jurisdiction over international trade in the House of Representatives, the Committee on Ways and Means will be the first in Congress to consider any trade arrangements or agreements reached with countries in this region.

Other actions taken to alter U.S.-trade policy with such countries also will be of interest to and possibly subject to the approval of this committee. These hearings will form an important part of the record upon which this committee will rely as it considers the future of United States trade policy toward the Soviet Union and Eastern Europe.

Before proceeding, I would like to note that our hearing this afternoon will focus on the issue of EC 1992. We will return to the subject of United States trade with the Soviet Union in Eastern Europe tomorrow.

Our first witnesses today are the Honorable Doug Bereuter of Nebraska and the Honorable Stan Parris of Virginia. Before I recognize them, I will yield to my colleague, Mr. Gibbons.

Mr. GIBBONS. Mr. Chairman, I thank you for this opportunity to participate in these hearings with you. This is truly an important hearing and important subject.

With Mr. Bereuter and also with others, I have visited this area a number of times. The problems over there are big and deep, and we need to get on with the most-favored-nation treatment, even if it's only for psychological purposes. These people need help and a boost; and while giving them most-favored-nation treatment wouldn't change a lot as far as their ability to trade with us, the psychological help is what they really need.

They need more than psychological help. They frankly need some hands-on help. The ones that I have talked to are not asking for money, but they are asking for assistance, and it doesn't need to be supercomputer-type assistance.

They need bookkeeping assistance. They need accounting assistance. They need people to put in place good, sound, election laws, and business laws most of all.

We must remember that since 1938, 1939, all of these countries have been dominated by someone other than their own people. The Nazis in the first part of the first 7 or 8 years, and the Russians ever since, and the infrastructure that is needed to run a marketplace economy is just not there.

The people who had the experience are dead and gone or else they are too old to actively participate in the running of the businesses over there. So there is lots that we need to do.

I want to commend you for having these hearings and tell you that as your chairman of the Subcommittee on Trade, I am anxious to get the go-ahead signal from you as to when we should proceed.

So I won't talk any longer. I see a lot of friends out there in the audience. In addition to Stan and Doug, I see Don; and I'm anxious to hear from you.

Thank you very much.

Chairman **Rostenkowski**. Any further comments from any other member.

Mr. Bereuter and Mr. Parris, we look forward to hearing your testimony. You may proceed.

STATEMENT OF HON. DOUG BEREUTER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEBRASKA

Mr. **Bereuter**. Mr. Chairman and members of the committee, thank you very much for this opportunity. These are particularly timely hearings and I congratulate you for holding them. As you just mentioned, Mr. Chairman, we are witnessing momentous changes in the Soviet Union and central Europe. I won't attempt to enlarge upon those changes; we all are watching them from day to day.

I will attempt to summarize my comments, which primarily discuss the subject of MFN status for the Soviet Union, and to a lesser extent, my comments can be applied in the same regard with respect to Czechoslovakia. I would ask unanimous consent that my entire statement along with the statement from the North American Export Grain Association be made a part of the record, and that I might be allowed to comment.

The changes to give us cause to examine the roots of our trade policy with Eastern Europe and the Soviet Union and to consider whether change in policy is in order. In recent months the Congress initiated sweeping changes in its relationships with Hungary and Poland, culminating in a $900 million assistance in change package to assist on their Central European and Eastern European nations.

In Czechoslovakia, I introduced legislation Thursday to remove Czechoslovakia from the list of countries that are not eligible for insurance programs for American businessmen offered by the self-supporting Overseas Private Investment Corporation. I was joined immediately by 20—the first 20 people whom I asked if they wanted to join. I will attempt to assist in pursuing this subject and other initiatives regarding Czechoslovakia through the Foreign Affairs Committee as well as the Ways and Means Committee this year. But while changes in central Europe are indeed dramatic, I am going to focus my remarks on the Soviet Union.

It is my firm belief that an objective review of the facts indicates that most-favored-nation treatment for the Soviet Union is in order and that the President of the Congress should move rapidly to expedite this process. The origins of Jackson-Vanik are, of course, understandable. At the time the Soviets levied a 30,000 ruble, or $1,220 exit fee, as well as an extortionist education repayment fee, to any Soviet citizen who wished to immigrate to a non-Communist nation. This, combined the emigration prohibition on anyone with access to sensitive information, and that was very broadly interpreted, effectively sealed the Soviet borders.

Now looking at the current status of our relations, I think there were good reasons for the original denial of MFN. In 1975, the Jackson-Vanik was an important tool in forcing the Soviet Union to carefully evaluate its immigration policy. But it is apparent to nearly everyone that times have changed. Accordingly, it is time to change our attitude towards economic relations with the U.S.S.R., not simply because the whole world is doing so, but because the Soviet Union under General Secretary Mikhail Gorbachev has initiated a policy of profound systematic reform. In short, the Soviet Union of 1990 bears little resemblance to the Soviet Union of 1975.

As a ranking minority member of the Human Rights Subcommittee of the Foreign Affairs Committee, I thought it would be appropriate for me to bring the following numbers to your committee. Emigration numbers are at their highest numbers ever for the Soviet Union. The U.S.S.R. permitted 1,944 emigrants, approximately 900 of whom were Jewish and none of whom were Pentacostal Christians. In 1989 just 3 years later, that number had skyrocketed to 195,000, of whom approximately 73,000 are Jewish and 14,000 are Penecostal Christians. Incidentally, the Soviet Union actually granted permission to emigrate in 1989 to an additional 25,000 people who have yet to make the personal arrangements to leave.

Indeed, we are now faced with a sensitive problem of being unable to absorb all the Soviet emigres who wish to come to the United States.

While it is certainly possible to nit-pick various areas of Soviet human rights policy and find problems and deficiencies, that approach misses the point. There has been a fundamental change in Soviet behavior and this change merits recognition.

Moreover, the reform policies of Gorbachev have been felt in other dramatic ways in recent months. The easing of Moscow's near-absolute control of its Eastern bloc satellites has resulted in economic and democratic reforms sweeping through Poland, Hungary, the GDR, Czechoslovakia, Romania, and Bulgaria. Within the U.S.S.R., unprecedented autonomy has been granted to the Baltic republics and elsewhere. The individuals in the various republic are for the first time selecting, or preparing to select, their own local leaders, rather than having them appointed by Moscow.

If the intent of withholding MFN was to affect changes in the Soviet Union, especially emigration and human rights policy, this goal has been achieved.

Now for the response by President Bush. To his credit, the President has recognized the importance of the changes that are occurring in the Soviet Union. Early in his administration, in his speech at Texas A&M in May, the President offered to work with the Congress to modify trade restrictions. More recently, as you all know, at the Malta Summit it was announced that negotiations on the necessary United States/Soviet trade agreement were to begin as soon as possible, and the complete draft would be ready for the June 1990 summit here in DC.

Under this timetable, the Soviets would have time to complete the ratification process for its new emigration law. This law, submitted in late November, has had its first reading before the Supreme Soviet and has been returned to the committee for minor technical modifications. These changes are expected to be complete very soon, and then it will be returned to the Supreme Soviet for a second reading when it reconvenes in the next few weeks.

In short, the Soviets are making a genuine good-faith effort to draft serious migration law. The passage of this legislation on their part, their long standing impediment to more open trade with the United States will have been overcome.

Admittedly, there are significant issues to be resolved in negotiation of a trade agreement. This is hardly surprising, given the nature of the Soviet system. For example, American businessmen need guarantees that when they open facilities in the Soviet Union, they may hire whomever they wish at whatever salary they judge to be fair. Of course, such business practices have been unheard of in the Soviet Union, where the state mandates both staff and salary. These are not trivial issues. Nonetheless, Mr. Chairman, the General Secretary and our President have instructed their respective trade negotiators that a trade agreement by June is a priority, and differences are being resolved at a speedy pace.

Finally, what can we expect from normal trade status or MFN for the Soviet Union? While MFN is important, I think it is also important that we not over estimate the possible contribution of MFN status to this Soviet economy. Yes, MFN treatment can be expected to improve trade. Yes, United States companies can be expected to improve their position vis-a-vis the Japanese and Western European competitors. However, MFN will not suddenly open the Soviet Union to a flood of United States goods, services, and agricultural products. Serious growth in trade will require years to develop.

The true importance of normal tariff status, and that is really how it ought to be expressed and how the law expresses it—not most-favored-nation status, but normal tariff status. For the Soviet Union the importance is symbolic. For years the denial of MFN status has been a signal to Moscow that it is not yet ready to join the family of modern industrial nations. Jackson-Vanik and the withholding of MFN has been the means of demonstrating our beliefs directly held that the Soviet Union has problems in its immigration law and policy.

The time for such change has come. The Soviet Union has earned consideration as an equal trading partner. We are the last nation to withhold normal trading status. The time has come for the President to approve a 1 year or 18-month waiver of Jackson-Vanik.

Mr. Chairman, members of the committee, we, the Congress, should do all we can, I believe, to encourage this process. I stand ready to help you when it comes to the floor and any other measure.

I believe that we should begin working to take apart the legislation that restricts trade with the U.S.S.R., at least by waiver. By offering no impediments, but also no special subsidies, we shall be sending a strong signal that the United States will give normal tariff status to the Soviet Union. In so doing, I sincerely believe we will not only help American business and labor interests and improve Soviet-American relations generally, but also we will be helping the democratization and equal reform process in the Soviet Union.

Thank you, Mr. Chairman. Thank you.

[The statement of Hon. Doug Bereuter and a statement from the North American Export Grain Association follows:]

DOUG BEREUTER
1st District, Nebraska

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AND URBAN AFFAIRS

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EXPORT TASK FORCE
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ENVIRONMENTAL AND ENERGY
STUDY CONFERENCE

"Trade Relations with the U.S.S.R."

Testimony of the Hon. Doug Bereuter
before Ways and Means Committee

January 30, 1990

Mr. Chairman and Members of the Committee, I thank you for the opportunity to testify this morning on future directions of U.S. trade policy. These are particularly timely hearings, and I congratulate you for holding them. As you are all aware, we are witnessing momentous changes in the Soviet Union and Central Europe. Nations that have for decades been adversaries are suddenly turning to the West in friendship. Throughout Central Europe the old, totalitarian dictators are being replaced by a fresh new leadership, committed to increased pluralism and economic reform. These changes give us cause to examine the roots of our trade policy with Eastern Europe and the Soviet Union, and to consider whether a change in that policy is in order.

In recent months the Congress initiated sweeping changes in its relations with Hungary and Poland, culminating in a $900 million assistance and trade package. I would note that initiatives are already being proposed to assist other Central European nations. For example, as a result of the political changes in Czechoslovakia, I have introduced legislation to remove Czechoslovakia from the list of countries that are not eligible for insurance programs for American businessmen offered by the self-supporting Overseas Private Investment Corporation. I will attempt to pursue this objective, MFN status, and other initiatives regarding Czechoslovakia through the Foreign Affairs Committee and the Ways and Means committee this year.

While changes in Central Europe are indeed dramatic, I will direct my comments today toward trade relations with the U.S.S.R., and whether it merits normal tariff status, or so-called MFN treatment. It is my firm belief that an objective review of the facts will indicate that Most Favored Nation treatment for the Soviet Union is in order, and that the President and the Congress should move rapidly to expedite this process.

I suspect you are aware, Mr. Chairman, that in recent years I have been active in seeking to enhance trade relations with the East. In 1987 and again in 1989, I introduced the Major Export Market Trade Equity Act (MEM). This bill would have the effect of lowering import duties to the U.S.S.R. and other Central European nations that are potentially major markets for U.S. exports. While I continue to believe that MEM would be appropriate in a variety of situations, I would like to focus today on the advisability of the U.S. joining all of our trade competitors by granting normal tariff status to the Soviet Union by granting a waiver of Jackson-Vanik and extension of MFN to the Soviet Union.

Background on Jackson-Vanik

For the better part of four decades, the Soviet Union and many of the Soviet bloc countries have been denied nondiscriminatory treatment in their trade relations with the United States. In recent years, U.S. trade policy with the U.S.S.R. has been controlled by the Jackson-Vanik Amendment to the 1974 Trade Act.

The origins of Jackson-Vanik are understandable. At that time the

Soviets levied a 1,000 ruble ($1,220) exit fee, as well as an extortionist "education repayment" fee, to any Soviet citizen wishing to emigrate to a non-Communist nation. This, combined with an emigration prohibition on anyone who had access to sensitive information (very broadly interpreted), effectively sealed the Soviet borders. Under the sponsorship of Senator Henry Jackson and Rep. Charles Vanik, the Congress overwhelmingly approved limitations on the conclusion of a trade agreement and the extension of MFN status to nations that restrict the right of their citizens to emigrate.

As you know, Mr. Chairman, Jackson-Vanik denies MFN treatment, denies U.S. credits and credit and investment guarantees, and prevents U.S. commercial agreements with nonmarket economy nations that deny their citizens the opportunity to emigrate, or impose heavy exit fees. As you are also very aware, the President has the authority to waive Jackson-Vanik if he determines that the nation has changed its policy and permits unhindered emigration, or if such a waiver would substantially promote the objective of open emigration. Of course, MFN treatment may then be granted by the President to those nations that are party to bilateral commercial agreements with the United States. This normal tariff status, MFN, continues only as long as the trade agreement remains in effect.

Predictably, the Soviets have decried Jackson-Vanik as an intrusion into the internal affairs of a sovereign state. For years they have been in no mood to offer any assurances regarding emigration, thus eliminating the possibility of a trade agreement.

Current Status of Relations

There were good reasons for denial of MFN in 1975, and Jackson-Vanik was an important tool in forcing the Soviet Union to carefully evaluate its emigration policy. But it is apperent to nearly everyone that times have changed. Accordingly, it is time to change our attitude toward economic relations with the U.S.S.R., not simply because the entire world is doing so, but because the Soviet Union under Mikhail Gorbachev has initiated a policy of profound, systemic reform. In short, the Soviet Union of 1990 bears little resemblance to the Soviet Union of 1975.

As the ranking minority member of the Human Rights Subcommittee of the Foreign Affairs Committee, I thought it appropriate to bring you the following numbers. Emigration numbers are at their highest levels ever. Consider that four years ago, in 1986, the U.S.S.R. permitted 1,944 emigrants — approximately 900 of whom were Jewish and none of whom were Pentecostal Christians. In 1989, just three years later, emigration has skyrocketed to approximately 195,000, of whom approximately 73,000 are Jewish and 14,000 are Pentecostal Christians. (Incidentally, the Soviets actually granted permission to emigrate to an additional 25,000, who have yet to make the personal arrangements to leave.) Indeed, we now face the sensitive problem of being unable to absorb all the Soviet emigres who wish to emigrate to the United States.

While it is certainly possible to nitpick various areas of Soviet human rights policy and find problems and deficiencies, that approach misses the point — there has been a fundamental change in Soviet behavior, and this change merits recognition.

Moreover, the reform policies of General Secretary Gorbachev have been felt in other dramatic ways in recent months. The easing of Moscow's near-absolute control of its Eastern bloc satellites has resulted in economic and democratic reform sweeping through Poland, Hungary, the GDR, Czechoslovakia, Romania, and Bulgaria. Within the U.S.S.R., unprecedented autonomy has been granted in the Baltic Republics and elsewhere. The individuals in the various republics are for the first time selecting or preparing to select their own local leaders, rather than having them appointed by Moscow. If the intent of withholding MFN was to effect changes in Soviet emigration and human rights policy, this goal has been achieved.

Response by President Bush

To his credit, President Bush has recognized the importance of the changes that are occurring in the Soviet Union. Early in his Administration, in a speech at Texas A&M in May, the President offered to work with the Congress to modify trade restrictions. More recently, at the Malta summit, it was announced that negotiations on the necessary U.S.-Soviet trade agreement were to begin as soon as possible, and that a completed draft would be ready for the June 1990 summit.

Under this timetable the Soviets would have time to complete the ratification process for its new emigration law. This law, submitted in late November, has had its first reading before the Supreme Soviet, and has been returned to committee for minor technical modifications. These changes are expected to be completed very soon, and then it will be returned to the Supreme Soviet for a second reading when it reconvenes in the next few weeks. In short, the Soviets are making a genuine good-faith effort to draft serious emigration law. With the passage of this legislation, their long-standing impediment to more open trade with the United States will have been overcome.

Admittedly there are significant issues to be resolved in the negotiation of a trade agreement. This is hardly surprising given the nature of the Soviet system. For example, American businesses need guarantees that, when they open facilities in the Soviet Union, they may hire whomever they wish, at whatever salary they judge is fair. Of course, such business practices have been unheard of in the Soviet Union, where the State mandates both staff and salary. These are not trivial issues. Nonetheless, Mr. Chairman, Gorbachev and Bush have instructed their respective trade negotiators that a trade agreement by June is a priority, and differences are being resolved at a speedy pace.

What We can Expect from MFN for the U.S.S.R.

While MFN is important, we should not overestimate the potential contribution of MFN status to the Soviet economy. Yes, MFN treatment can be expected to improve trade. Yes, U.S. companies can be expected to improve their position vis-a-vis their Japanese and Western European competitors. However, MFN will not suddenly open the Soviet Union to a flood of U.S. goods and services. Serious growth in trade will require years to develop.

The true importance of normal tariff status, MFN treatment, for the Soviet Union is symbolic. For years the denial of MFN status has been a signal to Moscow that it is not yet ready to join the family of modern industrialized nations. Jackson-Vanik and the withholding of MFN has been a means of demonstrating our belief that the Soviet Union remains a second-class state.

The time for such treatment has come to an end. The Soviet Union has earned consideration as an equal trading partner. The time has come for the President to approve a one year or 18-month waiver of Jackson-Vanik.

Mr. Chairman, we in Congress should do all that we can to encourage this process. The Congress should make it clear to western businesses and banks that, with the exception of specific national security concerns, their decisions concerning economic ties with Soviet ventures should be guided by economic consideration. We should offer American businessmen the opportunity to pursue business ventures in the

Soviet Union, and then let the open market take over.

But we should begin working to take apart the legislation that restricts trade with the U.S.S.R. By offering no impediments — but also no special subsidies — we shall be sending a strong signal that the United States will give notmal tariff treatment to the Soviet Union. And in doing so, I sincerely believe we will not only help American business and labor interests and improve Soviet-American relations generally, but also we also be helping to move forward the democratization and economic reform process in the Soviet Union.

Statement of

Steven A. McCoy
President
NORTH AMERICAN EXPORT GRAIN ASSOCIATION

Before a Hearing on U.S.-Soviet and Eastern European Trade

COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES
January 30, 1990

Introduction

It is an honor to appear before you today. I am Steve McCoy, President of the North American Export Grain Association (NAEGA), the national organization of U.S. grain and oilseeds exporting companies and cooperatives. I am here today to urge you and the Administration to continue your good efforts towards waiver of the Jackson-Vanik provision of the 1974 Trade Act, facilitating the process that will result in the granting of most favored nation (MFN) trade status to the Soviet Union.

We in the U.S. export grain community have been pleased to work with members of this Committee in recent months to achieve this important objective. We ask you today to rededicate yourselves to this task as we enter the second session of the current Congress and a promised new era of U.S.-Soviet economic and political relations.

We, of course, also look forward with great expectation to an improvement in our overall trade relations with Eastern European countries, following on the historic changes in that region which have, in a few short months, transformed the political face of the globe.

The opportunities presented by the altered political environment in Eastern Europe promise tremendous dividends for U.S. agriculture. Many of the problems we currently face in our trade relations with Eastern European countries are not dissimilar to those we face with the Soviet Union. We in U.S. agriculture must prepare ourselves to withstand the challenge of new, aggressive foreign competition for Eastern European and Soviet markets. The decisions this Committee makes this year on the matters before you today may, in the final analysis, significantly determine our success in meeting these challenges for many years to come.

Advantages of Expanded U.S.-Soviet Trade

The advantages of granting the USSR MFN trade status are self-evident to those of us engaged in U.S. agriculture. No other single U.S. government action in the international economic arena would, in our view, do more to advance the cause of building a stronger, more viable, more lasting and resilient U.S.-Soviet relationship than the action we seek here today.

We are, of course, delighted by the results of last year's Malta summit which, among other important accomplishments, has set us on the road to a more formal and comprehensive trade relationship with the Soviets. We are pleased that Jackson-Vanik waiver figured prominently among the issues discussed at Malta. We salute the President's leadership in forging a new U.S.-Soviet relationship; and note the important role played by Congress in this process, as indicated by the Downey-Moynihan resolution and other, equally positive statements on the issue by Congressional leaders of both parties.

We in U.S. agriculture are pleased to have been among the first groups in the Nation to have argued the merits of granting the Soviet Union MFN status. For a decade or more, farm groups and agricultural industry associations have placed achievement of USSR MFN status high among the policy priorities sought from the U.S. government, as evidenced by resolutions, legislative initiatives and petitions to Congress and the Administration. The matter was also proposed for specific remedy by the National Commission on Agricultural Trade and Export Policy, a Presidential advisory panel established by the Congress in 1985, which included membership by this Committee.

Until recently, U.S. agriculture's advocacy of USSR MFN status has been tempered by a recognition of the serious U.S. domestic political obstacles which lay ahead of achievement of such policy. However, the political and economic reforms now underway in the Soviet Union appear to have altered the U.S. political equation dramatically, admitting, for the first time since 1974, a strong likelihood that such a policy may be carried through to fruition.

We have an historic opportunity to serve the objective a more peaceful and constructive global political and economic environment. It is an opportunity which holds promise of substantial U.S. political and economic reward.

In agriculture, as in other segments of our national economy, we face unprecedented competition for worldwide markets. Our trade competition, in Europe, Japan, and elsewhere, flocks to press the advantages they now enjoy from unrestricted trade with the Soviet Union.

Waiver of the Jackson-Vanik provision and the granting of MFN status to the USSR offers us, in the United States, a chance to compete with other nations on an equal footing; to build new bridges to the Soviet economy and people; and advance the cause of peaceful worldwide political coexistence. It is an opportunity which should not be lost. The Administration and Congress should move swiftly to waive the Jackson-Vanik provision and advance the timetable for granting the Soviet Union MFN trade status. Failure to do so, given Soviet aspirations and expectations created in the current climate of improved U.S.-Soviet relations, could place in jeopardy our national interests and undermine our ability to be a force for change in the Soviet Union as that nation reaches out to establish its place among the trading nations of the world.

U.S Agriculture's Stake in USSR Trade

The NAEGA membership has an obvious interest in all matters affecting U.S.-Soviet trade. NAEGA companies exported U.S. grain, oilseeds and products to the USSR valued at over $2 billion in 1988, 74% of the value of all U.S. exports to the USSR that year. During the Long Term Grain Agreement (LTA) year ending September 30, U.S. exports to the USSR included 21.7 million metric tons (MMT) of grain, 1 million MMT of grain sorghum and 1.65 MMT of soybeans and products, valued at approximately $3.5 billion. We have sold the Soviets perhaps an additional $1.6 billion of commodities (principally corn) in the last four months alone, setting new export records along the way.

The value of U.S. agricultural exports to the Soviet Union in the five years 1984 to 1989 totalled over $11 billion. Grains and oilseeds have accounted for the lion's share of such sales; however, other U.S. agricultural commodities exported have included cotton, tobacco, dairy products, livestock products, specialty crops and fruits and vegetables.

These huge export figures bespeak the vital importance of the Soviet market for U.S. agriculture and U.S. trade. They also represent U.S. agriculture's significant contribution to the Soviet leadership's efforts to improve Soviet nutrition and living standards during a critical phase of transition to a more open and democratic Soviet socialist system under the dual policies of glasnost and perestroika.

Two-Way Trade A Problem

Soviet officials have long commented on the obvious disparity which exists between U.S. exports to -- and imports from -- the Soviet Union, citing, in particular, the current imbalance as it pertains to agricultural trade. Their complaints are not dissimilar from our own aimed at Japan and other countries with whom we have a serious trade deficit. As in the matter of U.S.-Japanese trade, Soviet complaints are borne out be the data.

For the eleven year period 1978-1988, U.S. exports to the USSR stood at $25.5 billion, compared with U.S. imports of Soviet products totalling $5.6 billion; or 22% of the total of U.S. exports.

Soviet exports to the U.S. as a share of total U.S.-Soviet trade reached a low point of 9% in 1982 and a high point of 33% in 1986. For other years, the Soviet share of total U.S.-Soviet trade has ranged between 18% and 24%. The Soviet share of total U.S.-Soviet trade in 1988 was 19%.

The problem of the U.S.-Soviet trade imbalance is undoubtedly exacerbated by a relative absence of Soviet products demanded by U.S. consumers, as compared with U.S. products -- particularly agricultural commodities and products -- currently in demand in the USSR. However, U.S. import figures also harbor the effect of denial of MFN status to Soviet products.

It is difficult to quantify the direct effect of the Jackson-Vanik sanction on Soviet imports. Suffice it to say that the Soviets themselves regard the effect as substantial. The matter of discrimination against Soviet imports has been a significant element in all recent U.S.-Soviet discussions on economic cooperation. It featured prominently in discussions during 1988 aimed at renewal and extension of the U.S.-USSR Long Term Grain Agreement (LTA). The Soviets argued then that U.S. failure to improve conditions of U.S.-Soviet bilateral trade made it difficult for them to commit to an agreement increasing annual minimum Soviet purchases of U.S. grain and oilseeds. In the final analysis, U.S. negotiators were, indeed, unable to achieve any increase in minimum Soviet purchases in the agreement entered into in November 1988.

The Soviets have since increased their annual purchases of U.S. grains and oilseeds above the minimums prescribed by the 1988 LTA agreement; but the issue of U.S. discrimination against Soviet imports persists nonetheless. U.S. and Soviet negotiators have begun again the process of renegotiating a new LTA. Bilateral trade is again among the issues under discussion in the context of that agreement. General bilateral trade relations -- and the Jackson-Vanik prohibition -- are not germane to the matters directly included in the LTA. Nevertheless, the issue of increased bilateral trade is in the background of all discussions affecting future Soviet purchases of U.S. grain.

It is not possible to quantify the impact which waiver of the Jackson-Vanik provision -- or granting of MFN status -- may have on conditions agreed to by the Soviets in the next LTA round. On the other hand, it is likely that a waiver will have an important psychological impact on Soviet attitudes toward U.S.-Soviet trade; and may eliminate the issue of discrimination as a matter of practical discussion altogether.

We in the U.S. export grain trade fully anticipate that the Soviets will continue to purchase U.S. agricultural commodities and products in considerable volume with or without waiver of the Jackson-Vanik provision this year. We are equally confident that Soviet purchases could increase with the granting of MFN status to the USSR.

This outcome is made all the more likely should the U.S. agree to extend the Soviet Union government guaranteed credit such as is possible under normal MFN terms. The Soviets have, in recent months, expressed their interest in new credit terms with non-U.S. government and foreign government commercial partners. Grants of new credit by private European and Japanese banks have been a feature of recent negotiations.

The Soviets have, we believe, a preference for doing business in the United States. However, the continued existence of sanctions prescribing discrimination and proscribing U.S. credit acts to undermine their faith and confidence in the United States as a reliable and willing trade partner in competition with terms offered by U.S. trade competitors. Waiver of the Jackson-Vanik provision would be an important first step toward reversing these attitudes. Conversely, maintenance of the such sanctions would unquestionably move the Soviets closer to our trade competition at the risk of loss of current trade benefits we enjoy in the USSR, benefits, as we have pointed out, that are skewed dramatically in our own favor.

Foreign Competition A Problem

We have no need to remind this body of the tremendous, often unfair, competition which U.S. farmers and industries face in the international marketplace. This competition is also a factor of our trade relationship with the Soviets. EC and Japanese governments have been quick to recognize the significant benefits which may accrue from liberalization of trade with the Soviet Union. Our failure to do likewise may have the effect of delivering the Soviet market into the arms of our most aggressive trade competitors.

As you know, the EC has recently concluded a comprehensive trade pact with the Soviet Union. Negotiation of this agreement included discussion of many important matters which promise to greatly improve EC leverage in the Soviet market in areas such as:

(1) the mutual granting of MFN treatment;
(2) non-discriminatory treatment;
(3) progressive removal or suspension of EC quantitative restrictions;
(4) non-injurious USSR pricing;
(5) safeguards for EC unilateral measures;
(6) commercial and economic information exchange;
(7) cooperation between EC and Soviet customs services;
(8) encouragement of arbitration for the settlement of commercial disputes;
(9) assurances relative to intellectual property and the cooperation between EC and Soviet institutions on patents, trademarks and other intellectual property rights;
(10) agreement relative to the entry, stay and movement of EC business representatives in the USSR and improving direct access to business contacts and end-users throughout the USSR;
(11) establishment of representative offices of EC firms in the USSR, including the renting of commercial premises, the acquisition of equipment and transport facilities, telecommunication lines, etc.;
(12) the freest possible recruitment of local staff required by EC firms in the USSR; ensuring non-discriminatory pricing of local services and support relative to any third country;
(13) individual and property rights guarantees;
(14) discouragement of compensation transactions;
(15) free choice to EC firms concerning transporters and insurers in their contracts with Soviet enterprises; and
(16) non-discriminatory treatment in the awards of contracts for the supply of goods and services upon international invitations to tender.

The scale of matters included and activities subsumed within recent EC-USSR trade negotiations must give us pause to contemplate our own evident insecurity in the Soviet market, enjoying no similar guarantees or assurances. The U.S. must, without delay, move forward aggressively on a path dedicated to renegotiation and renewal of the lapsed U.S.-USSR trade agreement of 1972, itself the early victim of the Jackson-Vanik provision. We are pleased that our government and negotiators have begun such a process looking toward the June Presidential summit.

Such a process cannot, quite obviously, be undertaken in earnest without swift decision governing the Jackson-Vanik provision. Even then, the difficulties involved in renegotiating the 1972 agreement may prevent our achieving the necessary progress to overtake the head start already accomplished by the EC and other U.S. trade competitors. Rapid, granting of full MFN status to the USSR alone, in our view, can stem the tide of trade benefits so clearly now turning in the favor of our trade competition. Redirecting those benefits in our own direction shall demand the solid commitment and dedication of the Administration and Congress. The likely results of further delay are there for all to see.

Closing Comments

We have limited our comments today largely to matters pertaining to U.S.-Soviet agricultural trade and problems associated with competition in the Soviet market. We have not commented on the effect of liberalized U.S.-Soviet trade on U.S. investments and joint ventures in the USSR, although we share the view that such activities would clearly benefit by waiver of Jackson-Vanik and the granting of Soviet MFN status. Neither have we have discussed in detail issues pertaining to trade with Eastern European countries. Suffice it to say that we seek similar progress in our relations with these countries and support Congressional efforts to build new bridges of trade and cooperation with countries in that region of the world.

U.S.-Soviet trade -- and U.S. trade with East Bloc countries -- is a significant and emotional matter for U.S. agriculture. The Nations's agriculture still reels from the effects of the 1980 foreign policy grain embargo against the Soviet Union; and the effect of an earlier short supply embargo against Poland.

No sector of the U.S. economy has fought as hard to achieve access to the Soviet market as U.S. agriculture; nor suffered as greatly by U.S. policy designed to frustrate U.S.-Soviet trade. By history and experience, U.S. agriculture is well placed to advise on the benefits of U.S.-Soviet trade; and the folly of economic sanctions applied against the USSR. Our vote comes down firmly in favor of waiver of the Jackson-Vanik provision and rapid progress towards granting of MFN status to the Soviet Union. Our case is much the same applied to enhanced trade relations with the countries of Eastern Europe.

We have spoken earlier of the agenda of opportunity we now face in U.S.-Soviet and Eastern European trade relations. Success in advancing that agenda now rests firmly in the hands of the Administration and Congress. We, of course, stand ready to do what we can to assist the process of U.S.-Soviet and Eastern European trade expansion. We do so recognizing not only our own interests but the interests of the Nation, of the Soviet and Eastern European peoples, and the people of the world.

We appreciate the opportunity to testify today. Thank you.

Chairman Rostenkowski. Mr. Parris, please proceed.

STATEMENT OF HON. STAN PARRIS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF VIRGINIA

Mr. Parris. Thank you very much, Mr. Chairman. Let me express my appreciation for letting me be with you today and amongst my friends on this committee.

I will be very brief. I have prepared remarks for the committee, but I will attempt to summarize them and ask that my full statement be inserted in the record.

There is no question, as my friend from Nebraska has just said, that the events in Eastern Europe have dramatically changed the legal, social, and economic policies in those countries.

While each country has acted independently of the others, the members of that area have taken giant steps toward the establishment of some democratic form in their respective nations.

Taking those steps, they have turned away from centralized economies in increasing numbers to the establishment of a free enterprise system. And in order to stabilize their economies and provide these needed currency complete to reform, I think these actions should be encouraged and rewarded.

I was very pleased by the comments of my friend from Florida, Mr. Gibbons, in his opening remarks in that regard. Such encouragement should be based on the establishment of long-term initiatives which create mutually beneficial trade jobs rather than direct aid, in my view, direct aid being fleeting and temporary.

One economic initiative which would bring about these goals would be to extend most-favored-nation treatment and status to the Eastern Europe nations currently undergoing these major political revolutions.

Now, my comments, Mr. Chairman, are directed solely toward the nation of Romania. The benefits to be obtained from most-favored-nation status are obvious to all of us and known by all of us.

Between 1975 and 1985, for instance, bilateral trade between the United States and Romania increased fourfold—$450 million to $1.2 billion—creating many thousands of jobs in both of those nations.

For a fledging government struggling to incorporate democratic principles into its scheme of—situation in its nation and to survive and grow, its economic house must be put in order quickly with an infusion of tangible capital and goods.

While not a panacea, MFN would help provide the recipient countries with an economic foundation upon which they may build their new governments.

It has been said as well many times, Mr. Chairman, that the granting of MFN status to a non-market-economy nation permits the social reforms; it enhances the acceptance of the social reforms which are a part of the transition of that political system.

For all of those reasons, Mr. Chairman, I have introduced House Concurrent Resolution 245, calling upon the President to reextend the MFN status to Romania. I limited that resolution to Romania, Mr. Chairman, because it's the only non-MFN status Eastern

Europe country that has a valid, existing bilateral trade agreement with the United States.

I am not arguing that the consideration should not be extended to others. I am simply saying that that nation happens to be the one that has the existing requirements for the bilateral trade agreements now.

The second of the two prerequisites to MFN status under the Trade Act of 1974 is a major economic move, obviously. And understanding, if you will, it's only one of several tools of economic assistance that Congress and the administration could be offering—and in my full statement, Mr. Chairman I will not go through them, I have elicited five for instances that the committee may want to consider, including extending Eximbank guarantees, Commodity Credit Corporation programs, OPIC programs, generalized system of preferences, all of those things can and should be considered.

We have, in my view, a unique set of circumstances in Eastern Europe and an opportunity to reach out as has been said by Mr. Gibbons to those countries. We also have the tools to further the cause of freedom and self-determination in those nations, and what we may not have is time.

And I would conclude my remarks, Mr. Chairman, by requesting unanimous consent to enter into the record a letter that I am expecting to receive tomorrow from the president of the university student groups from Bucharest, which certainly supports my position, and also insert for the record a letter to the president from the chairman of the American Businesses for International Trade here in Washington.

And let me just read the last two sentences of that letter. It says, "American businessmen want to be players rather than spectators in the drama that is unfolding there," meaning Eastern Europe. Our competitors from Europe and Asia are already in Bucharest, and I think I can speak for those—for that group, Mr. Chairman, when I suggest to you that when the Japanese and the Germans and everybody else is already hard at work, it will behoove this nation to sit by and watch the unfolding of the developments in that area.

And I thank you very much.

[The letters referred to were not received by the committee.]

[The statement of Hon. Stan Parris and an attachment follow:]

Statement of Congressman Stan Parris
Before the House Committee on Ways and Means
Hearing on
"Examination of U.S. Trade Relationships with the Soviet Union and Eastern Europe"
January 30, 1990

Mr. Chairman, I want to thank you and this Committee for giving me the opportunity to appear before you today. I would also commend the committee for holding these very timely hearings to examine U.S. trade relationships with the Soviet Union and Eastern Europe, the implications of "Europe 1992" on American direct investment, and foreign investment in the United States.

As you noted in your press release, Mr. Chairman, "in the recent weeks and months, a change of historic proportions has taken place in the Soviet Union and Eastern Europe". The events in Eastern Europe are dramatically changing the legal, social and economic policies in those countries on a daily basis. These changes are causing leaders throughout the world to examine their countries policies towards and dealings with the Eastern European bloc. While each country has acted independently of the others, it would appear that the Eastern European bloc has collectively decided to throw off the yoke of communist rule, and the members have taken giant steps towards the establishment of some form of democratic rule for their nations. In taking these steps the people of Eastern Europe have turned away from a centralized economy and are turning, in increasing numbers, to the establishment of a form of free enterprise in order to stabilize their economies and provide needed currency to complete their reform.

These actions should be encouraged and rewarded. Such encouragement should be based on the establishment of long term initiatives which create mutually beneficial trade and jobs rather than direct aid, which is fleeting. One economic initiative which would bring about these goals would be to extend Most-Favored-Nation (MFN) status to the Eastern European nations currently undergoing social, legal and economic "revolution".

By law, MFN status obligates contracting parties to extend all concessions or favors made by each in the past, or which might be made in the future to any other state in such a way that their mutual trade will never be on a less favorable basis than is enjoyed by that state whose commercial relations with each is on the most favorable basis.

Although several variations exist, MFN clauses generally take either of two forms - the conditional or the unconditional. States employ the conditional clause to restrict MFN treatment to existing concessions. To secure MFN treatment as to new concessions, the grantee state must reciprocate with compensating concessions of its own. With the unconditional clause, however, the grantor state confers MFN status as to both existing and future concessions.

An MFN clause enhances international commerce by discouraging barriers to trade. Each state party to an MFN treaty provision may not discriminate among the other contracting parties in imposing tariffs and other customs regulations. The most-favored-nation for each party becomes the benchmark for determining the severity of these trade barriers, and each contracting party must lower its barriers as to the other contracting parties to conform to that benchmark. The resulting freer trade produces significant economic benefits.

It is interesting to note that the United States, in its first treaty as an independent nation, entered into a conditional most-favored-nation agreement with France. In the Treaty of Amity and Commerce of July 17, 1778, the United States agreed to grant to France, the treaty partner, any concession which the United States granted to any third nation, but provided that if any measure of compensation was obtained, similar compensation would be required as a condition of granting the concession to France. This MFN treaty proved to be of epic importance both economically and legally to the United States.

Another significant episode from U.S. MFN history was our denial between 1951 and 1974 of MFN status to communist nations, referred to as Non-Market Economy country's (NME), because the principal aim of United States policy at the time was the isolation and containment of the Eastern European states.

The extension of MFN status has many positive economic ramifications for the recipient country. Conversely, the denial of of MFN status has meant that the products of non-market economy countries, generally communist countries, are subject to the full tariff rates provided for in the rate column 2 of the Tariff Act of 1930. All other countries enjoying MFN status receive treatment under the much lower column 1 rates, which have been the subject of periodic reductions resulting from trade concessions. Thus, existing tariff discrimination is based on the difference between tariffs imposed under the two columns. When this difference exceeds five percent, it is considered by the International Trade Commission to be substantial discrimination.

A 1971 research study by the United States International Trade Commission concluded that U.S. imports from nine Communist countries would have been at least 10% higher if they had enjoyed MFN status.

But in actuality, extending the MFN to NME countries proved to be even more economically beneficial than the ITC imagined. The Trade Act of 1974 allowed for MFN status to be extended to NME country's upon certain findings being made by the President and concurred in by Congress. Romania, a beneficiary of that act, was extended MFN trade status in 1975.

Under the MFN, trade with Romania expanded enormously. In 10 years, bilateral trade increased fourfold from $450 million to $1.2 billion in 1985. After receiving the right to sell in Romania, over 30 American companies set up sales offices there. One major American-Romanian joint venture was set up on Romanian soil to produce computer products. Leading American sales included food processing equipment, agricultural products and equipment, chemicals, and non-strategic computing equipment. The economic benefits realized as a result of MFN status helped Romania to maintain a greater degree of economic and political independence from the Soviet Union. Fifty-five percent of Romania's trade was with the West, while for the other East European countries, about 65 percent was with the Soviet bloc. MFN also contributed to the further integration of Romania into the world trading system, and encouraged Romanian compliance with the rules and obligations of that system.

MFN status has proven to be more than an economic instrument for the U.S. and recipient countries. It has also been used very effectively in bringing about social reform in NME countries. Provisions within the Trade Act of 1974, such as the Jackson-Vanik Amendment, linked the granting of MFN status to an NME state to its maintenance of a free emigration policy.

More specifically, the Jackson-Vanik Amendment provides that the United States will not grant MFN status, credit, or investment guarantees to, nor will the U.S. conclude a commercial treaty with an NME state. The President may waive these prohibitions by certifying to Congress that the NME state neither denies its citizens the opportunity to emigrate nor imposes exorbitant taxes or other penalties on visas and other documents required for emigration. Under the Amendment, the nominal term of a bilateral trade agreement with an NME state may be as long as three years. The annual certification requirement, however, effectively shortens the duration of a trade agreement with an NME state to only one year.

Since its passage in 1974, the Amendment has, in some cases at least, contributed to the liberalization of NME states' emigration policies. For example, the average emigration rate from Romania to the U.S., Israel and West Germany nearly tripled in the decade after it was extended MFN trading status, including a sevenfold increase in emigration to the United States. Over 154,000 Romanians, roughly one in 160 of the country's current population departed the country legally under the MFN. The MFN had some impact on the conditions under which emigrants left Romania. The United States was able to secure from Romania's previous government an agreement to new procedures which alleviated some hardships encountered by individuals approved for emigration, such as loss of employment, housing, and access to social services. The linkage requirement seems to be an effective tool for influencing NME states' human rights policies. Annual MFN review has allowed the United States to highlight individual human rights cases and in a few instances satisfactorily resolve them. A linkage requirement provides a continuing incentive to the NME state to satisfy the human rights conditions on MFN treatment.

America's heritage has taught us that when a nation undergoes social, political, and legal turmoil, strong economic underpining is essential to providing a sound base for a fledgling nation to survive and prosper. The Eastern European countries are undergoing massive turmoil and turbulent change. What is needed is a friendly hand proffered with the promise of long lasting economic assistance. MFN has proven, in its limited application by NME countries, to provide such economic assistance while at the same time fostering essential social reforms, though limited in amount.

The United States should move quickly under the terms outlined by the Trade Act of 1974 to extend MFN trading status to the Eastern European NME countries. It appears, from the reports coming out of Eastern Europe, that the NME countries are taking steps and instituting measures that have or will comply with the standard set forth under the Jackson-Vanik amendment for the extension of MFN trading status. This extension would provide the needed economic foundation for these countries undergoing change, and would give them a great measure of economic security, while at the same time lessening their economic ties to the U.S.S.R.

I would like to remind the committee at this point that on last Wednesday I introduced H.Con.Res. 245, calling on the President to immediately move to extend MFN to Romania. Again, I believe it is critically important for the U.S. to consider timely MFN extension to all of the NME countries currently experiencing significant social and political change. My bill, however, recognizes the fact that Romania is the only one of them with whom the U.S. has a valid existing bilateral trade agreement -- one of the two prerequisites to MFN extention, the other being compliance with Jackson-Vanik.

While extension of MFN trade status is important, it should by no means be the only economic measure Congress and the President should consider granting the Eastern European countries.

In times of fiscal austerity, significant direct financial aid is, out of necessity, removed from consideration. Moreover, mere financial aid does not provide the economic foundation nor present the economic security that the NME countries need. Direct aid is generally, a one shot approach which must rely on the Congressional appropriations process. The NME countries do not have their hand out begging for aid to be thrown their way. Instead they have taken positive steps, without regard for their own financial welfare, to bring about a change from what they have felt has been a regressive, repressive, and unresponsive political and economic regime. They are looking for long lasting economic programs that will go hand-in-hand with their political and economic reforms.

Other measures that Congress and the Administration should consider extending the Eastern European countries include:

(1) Expanding the "Support for Eastern European Democracy Act of 1989", P.L. 101-179 (November 28, 1989) (SEED Act) to include other NME countries;

(2) Extending Ex-Im Bank guarantees and funding for exports;

(3) Making available Commodity Credit Corporation programs - Credit Guarantee Program and Export Enhancement Program;

(4) Utilizing Overseas Private Insurance Corporation programs - Political Risk Insurance and loan guarantees to foster increased trade and expand exports with Eastern Europe;

(5) Exploring the application of Generalized System of Preferences for Eastern European nations.

These programs are not mutually exclusive nor do they exhaust the creative powers of Congress and the Administration in the trading arena. The Eastern European nations have taken enormous strides in a very short time, without outside assistance, to correct past wrongs and venture down the road towards freedom and self-determination. We have been there before. It can be a lonely road. Let us not turn our backs on our friends and neighbors which have so many ethnic and cultural ties with our own country. Let us stand ready to lend assistance when needed and asked for by our courageous Eastern European cousins.

Chairman **Rostenkowski**. Thank you.

Any other comments?

Mr. **Pease**. Thank you very much, Mr. Chairman.

Let me thank our two colleagues for spending some time with us this morning and thank them for their testimony.

I would like to direct a question to my colleague from Nebraska. The emphasis of Jackson-Vanik, of course, is immigration; and certainly the Soviet Union has announced a significant easeup on immigration. I would like to ask a question about whether we can differentiate or should differentiate between the East bloc countries other than the Soviet Union on the one hand and the Soviet Union on the other?

I was in Czechoslovakia 2 weeks ago. That country is determined to move as quickly as possible to a free market. It's also determined to move to a multiparty democracy. I think the same thing that we said to a lesser extent, perhaps not, but even to a greater extent, Hungary and Poland.

In the U.S.S.R., on the other hand, the Communist Party has not renounced its monopoly on power and has shown no sign of doing so. Soviet officials quite apparently intend to stick with a planned, centralized stated controlled economy. That is in stark contrast to what the leaders of Czechoslovakia, Hungary, and Poland have in mind.

My question is, Should our policy in granting MFN seek at all to differentiate between the Soviet Union on the one hand with its continued commitment to one-party rule and to a state-controlled economy, and to the other countries of Eastern Europe on the other, when their commitment is to the free market principles and multiparty democracies?

Mr. **Bereuter**. Thank you very much for your question, Congressman Pease. We have differentiated in the past on granting of MFN. I expect, at least in order of action, we should appropriately differentiate now.

It's important to understand, though, why we are differentiating and not use this differentiation inappropriately. In my judgment, MFN was granted to Romania primarily because it differentiated its foreign policy. Also, there were no Soviet troops in Romania, uniquely, along with Bulgaria.

That was the reason for granting of MFN. Of course, Romania stood out as having the most repressive policy toward their citizens and especially the minority of any nation.

So, I have always thought that was exactly the wrong reason to differentiate. The Jackson-Vanik amendment is aimed at emigration policy, and trying to assure that the people have an opportunity to immigrate. That is why the Soviet Union, I think, has demonstrated that a waiver of Vanik by the President, with the appropriate treaty action by the Congress, is appropriate.

We should measure the Soviet Union's performance on immigration policy and not, it seems to me, try to include everything under the umbrella.

Czechoslovakia clearly ought to be at the top of the line for MFN, as well. And we should watch carefully to see what happens with respect to Bulgaria as they treat their Turkish ethnic citizens. We will also watch to see what happens in the GDR.

But I think its important to remember what the reason for Jackson-Vanik really is. That is migration policy reform.

Mr. PEASE. Well, in my question, note that I was extremely careful not to put Romania in the same camp as Czechoslovakia, Hungary, and Poland. I agree with you on the inappropriateness of our decision earlier on to grant MFN to Romania.

I take it that since you would grant MFN solely based on whether a nation's emigration policy was satisfactory or not that you would not use MFN as a tool to encourage a nation to move toward free market principles and multiparty democracy——

Mr. BEREUTER. Mr. Pease, I would base the decision of granting normal trade status primarily, predominantly on what the law says. I don't think we can exclude other factors. We have other means for attempting to leverage action in that area for responding to democratization and pluralization in those societies.

Mr. PEASE. Thank you very much.

Chairman ROSTENKOWSKI. Any other questions?

Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman. I apologize for being late and not hearing your testimony.

Doug, I have got to say there were some of us who were opposed to MFN in Romania who saw through the charade. And even though the administration and members of this committee were blinded by Mr. Ceausescu and his explanations of how they had a differential foreign policy, if we live long enough, I guess we realize that some of us were right in our opposition to MFN for Romania.

I have one question that bothers me. We do not refer in MFN any more to Communist countries, but non-market-economies. And the basis of that is that it's—there is a difference between a market oriented economy and a nonmarket economy, and it's extremely difficult for the private sector of a market economy to compete with a nonmarket economy for subsidized provider.

Now, if you can tell me how we solve this, how we gradually move; and quite frankly, we'd say, I think, that is the main benefit of Jackson-Vanik.

You can talk all day about emigration policy and that just as a result of these nonmarket economy countries or repressive-type governments; but if you can, tell me if I am a small manufacturer how my country is going to move me into a position whether to take policies, trade policies at this level so that I am not put behind the eight-ball, put out of business and my employees put out of business.

Now, I am in a position to compete. I am paying my employees. I am paying social security. I am paying my taxes, my utilities, my transportation, my insurance, overhead, and a non-market-economy country where somebody or a socialized country, however you want to term it, whether the Government is paying either all or a portion of that overhead, dictating a portion of it, but controlling a portion of it, if you can, tell me how we can put our trade laws in line so that we can gradually move these people into market economies or so that we can give a degree of protection to—against unfair trade to that small manufacturer or producer? That seems to be the key.

And then we can get rid of MFN. But let's not get rid of MFN and say to the fellow who is out there trying to compete in an ever increasingly competitive international marketplace that we are going to dump you in the river along with these policies.

I don't know whether that was a question or a statement.

Mr. BEREUTER. I regard it as a question, an opportunity for me to respond briefly at least, Congressman Schulze.

Thank you for your concerns. I share the concerns, but granting normal trade status will enable our businessmen to market in those societies as they have an opportunity to generate hard currency.

The balance of trade between the Soviet Union and the United States averaged over the last few years has been 5 to 1 in our favor. Where we have a leverage and where we have to make the changes in their society to move them away from a nonmarket economy if they want to play in the international field is in GATT.

The Soviets have asked for status. But they are far away from qualifying for all the arrangements that could bring it up into GATT, if they want to have GATT membership.

Mr. SCHULZE. That is worthless. In the international trade arena, GATT is worthless.

I would love to see GATT as a good, strong policeman of international trade, standing up for what is right and having the ability to say, whoa, whoa, whoa, that is unfair competition.

Mr. BEREUTER. Well, I see my——

Mr. SCHULZE. Let me tell you that nonmarket economy countries, in many instances, their sole goal is to secure hard currency. And they will develop—Adam Smith never envisioned a world in which countries, nations would develop product lines solely to secure hard currency. And you tell me how a producer competes in that situation.

I tell you it's impossible under today's laws, under GATT, under our trade laws. And so if we are going to do this, we have to develop a new structure.

Mr. BEREUTER. Very briefly, I share your frustrations with GATT, and it's going to be very difficult making this intereconomics between nonmarket and capitalist kinds of societies. But I will tell you this, the Soviet Union is knocking on the door as hard as they can to get into GATT, so apparently they find some advantage.

Mr. SCHULZE. That is why we have to give some thought to it. I agree with you, but we cannot just go blindly——

Chairman ROSTENKOWSKI. Mr. Cardin.

Mr. CARDIN. I want to thank both our colleagues for their interest in leadership in this area.

Congressman Bereuter, I think there is a question that I want to ask you. Jackson-Vanik has been a success. Its specific goal was to deal with immigration. Its general goal was to deal with human rights issues, particularly within the Soviet Union; and there has certainly been a remarkable change since the passage of Jackson-Vanik.

I think most people believe that the waiver certainly should be considered. I do take issue, though, with one of your statements, and that is that those people who are pointing to problems within the Soviet Union, I think you used the word "nit-picking," and there are still serious problems within the Soviet Union as it relates to state secrets to prevent people from having the Soviet Union and the way that they allow people to practice their religious beliefs within the Soviet Union.

Assuming Jackson-Vanik is waived, as the ranking minority member of the Human Rights Subcommittee on Foreign Affairs, I am wondering if you have any suggestions on how the United States can maintain its high profile in the world community on human rights issues, particularly as it relates to the Soviet Union?

Are there other avenues that we should be exploring if we don't have the trade leverage over the Soviet Union?

Mr. BEREUTER. Thank you very much. I certainly don't mean to minimize the problems that we see in the Soviet Union. Certainly in the area of ethnic friction, for example, human rights abuses in that area are going to be something they will deal with for a long time. And we have to be concerned about that.

I am simply saying not to repeal Jackson-Vanik. It has been helpful as you point out. But a waiver now is appropriate. We said, and if we want to have any credibility, by legislative action, that it was aimed at emigration problems. Now that they have taken action in that area, it seems only appropriate to respond if we are to have some credibility for them to be motivated to move in other areas that relate to human rights and a whole range of antidemocratic ramifications in their society.

It's in our interests to respond, and it's in our interests to help Mr. Gorbachev proceed with economic reform, democratization, and pluralization reform.

So I think a whole variety of exchange programs, I think that continued scrutiny by a whole range of nongovernmental organizations looking at human rights, I think visits of committees and Members to the institutions that are currently abusing human rights or alleged to be abusing human rights, such as the penal, psychiatric systems, are important.

We must maintain that emphasis.

Mr. CARDIN. So your point is that we should waive Jackson-Vanik, not to repeal the statute.

Mr. BEREUTER. Right. Absolutely.

First of all, we cannot, it's enshrined. Second, it's appropriate to keep that leverage there in my judgment. When they meet the requirements of Jackson-Vanik, we have to go along not an open-ended, but a specific period of theirs.

Mr. PARRIS. Mr. Cardin, could I just respond briefly to your question. Generally, my view, MFN should be used as an affirmative act on the part of the United States to reward, and as a tool, to further positive moves in the area of human rights, social reform, and that sort of thing, and in the current case of freedom and Democracy, move towards pluralism and Democracy, freedom.

The Soviet Union is a considerably more complicated situation, but in the case of Romania, the reinstatement of a bilateral trade agreement to me ought to be a slam dunk for the United States.

That is the distinction that I make in my approach to this whole problem, and I do not mean to minimize the complexity of it, but in this individual case, the reinstatement is a totally separate question to me than the initial creation of a bilateral trade agreement.

Mr. **Cardin**. Thank you, Mr. Chairman.

Mr. **Gibbons**. I will be brief.

Mr. Schulze's statement worries me. With his long participation on this committee, I know that he is aware of the fact that we do have antidumping laws, and that that is what we use against nonmarket economies.

All laws operate after the fact. You cannot be convicted of murder before you commit one, and you cannot be found to be engaged in dumping. The law, does, however, go to more than just injurious dumping. It goes to a threat of injury caused by dumping.

And so I just want to correct the record about that. Thank you very much, gentlemen.

Mr. **Bereuter**. Thank you.

Chairman **Rostenkowski**. Mr. Kendall, Mr. Murphy, welcome to the committee, gentlemen.

If you will identify yourself for the record, and then proceed in you—any of your testimony, the committee is ready to proceed.

Mr. Kendall.

STATEMENT OF DONALD M. KENDALL, CHAIRMAN, AMERICAN COMMITTEE ON UNITED STATES-SOVIET RELATIONS, AND CHAIRMAN, EXECUTIVE COMMITTEE, PEPSICO, INC.

Mr. **Kendall**. Thank you very much, Mr. Chairman.

I am Donald Kendall, chairman of the executive committee of PepsiCo and am here representing the American Committee on United States-Soviet Relations.

Chairman **Rostenkowski**. Mr. Kendall, would you bring the microphone a little closer.

Mr. **Kendall**. First, I want to thank Chairman Rostenkowski and the rest of the committee for holding these hearings. I am here on behalf of the American Committee on United States-Soviet Relations, and also as a private citizen, with over three decades selling Pepsi to the Soviets.

With the chairman's permission, I would like to enter my written statement in the record, and I will summarize the major points.

Chairman **Rostenkowski**. You are entitled to have the statement made part of the record.

Mr. **Kendall**. I want to start by briefly explaining PepsiCo's experiences with the Eastern bloc, because I think it has implications for overall American policy.

PepsiCo has a long history of trade with the Eastern bloc nations. It began at the American National Exhibition of Moscow in 1959 when I convinced Premier Nikita Khrushchev to drink a bottle of Pepsi. Our advertising campaign at the time was "Be Sociable, Have a Pepsi."

After Khrushchev drank the Pepsi, and Vice President Nixon was there, there were headlines around the world showing Khrushchev drinking Pepsi, and the headline was, "Khrushchev Learns To Be Sociable."

Fifteen years later, the first Pepsi plant was built in the Soviet Union. Today there are 24 plants in the U.S.S.R. and we are about to sign an agreement to build another 28 plants there. When these new plants are operating, we will be selling as much Pepsi in the Soviet Union as we were in the United States when I joined the company.

Across the rest of Eastern Europe, there are another 39 plants. In fact, we hold the lead in the cola market share in every Eastern bloc country but two, East Germany and Albania. I am not sure Albania even has a soft drink.

We have learned a lot from three decades of dealing with the Eastern bloc, but three lessons stand out.

First, we have learned to be patient, very patient. Fifteen years is a long time to negotiate and wait for the construction of the first plant. But stop and consider the U.S.S.R. has 289 million potential soft drink lovers. Even with our 24 plants operating today, we sell the same amount of soft drinks a year in that entire country as we sell in the State of Oklahoma. You can understand why we believe it pays to take a long view, despite what the Japanese like to say about American industry.

Second, we have learned to be very creative. We were faced with the challenge on how to remove our profit from countries where the currency can't be converted. We solved that challenge by trading Pepsi concentrate for the right to supply wine from Hungary, Bulgaria, and Romania, and Stolichnaya vodka from the Soviet Union.

The third lesson we learned is that we had to proceed without the help from our own Government. The reason is simple. For three decades American policy has been subservient to foreign policy and I don't believe that it worked. I point to the Jackson-Vanik amendment as a perfect example.

Jackson-Vanik had no impact on Soviet emigration policy. In 1972, the year the amendment first passed, immigration totaled almost 35,000. In 1985, it was down to about 1,000.

Now, finally, I sense the political environment is changing in the United States. It appears we are finally ready and looking to make trade policy an equal partner of foreign policy. I hope the committee will follow this philosophy as they debate trade policy in the coming months. Specifically, I urge you to consider some immediate action. I mention five in my written statement. I would like to focus on the three most important. I should add that these changes are similar to the ones put forth by President Bush and Secretary Baker in Malta in December.

First, Jackson-Vanik. The President and prominent Jewish organizations advocate waiving the amendment. Because of the improved Soviet attitude toward Jewish emigration, I say go a step further and repeal it altogether. Only complete repeal will assure American businesses that they can move ahead and look at ways to promote countertrade without fear that exorbitant tariffs would be slapped on 2 or 3 years down the road. Once you repeal Jackson-Vanik, you clear the way for a trade agreement with the Soviet Union.

I believe we should grant most-favored-nation trade status to the Soviets as well as to Bulgaria, Czechoslovakia, East Germany, and Romania. I have long favored MFN status for these countries, because I have always believed that the stiff wind of free enterprise can help knock down even the strongest totalitarian wall.

Today, as these nations experiment with markets and political freedom, the positive impact of trade has never been greater. That is two reforms.

Third, I hope you will support the administration in allowing the Soviets to become an observer at GATT meetings. As the members of this committee know far better than I, the GATT negotiations have a tendency to go on and on and on. So you might argue that letting the Soviets watch is sufficient punishment for 40 years of adhering to Socialist doctrine.

But I think the Soviets would also learn something, and I believe their inclusion is consistent with GATT's original purpose, to promote international economic growth and reduce political tensions.

Those are my major recommendations. I hope the committee will act on each of these this spring. I would like to close with a personal observation.

There is a lot of talk now about what we can do here in America to support the changes underway in the Eastern bloc. I think we have to keep something in mind. No one has ever walked the long road from state-based socialism to a market-based economy, from a highly centralized economy to a market economy. The Eastern bloc nations are the first to trod this path, and they are going to have to walk it themselves.

So I am not much for grandiose strategies of assistance or second Marshall plans. What I am for is more trade and more joint ventures as fast as possible.

One story from Pepsi's experience should illustrate why I feel this way. Last year, Pepsi helped sponsor something called the World Music Video Award. I am not a real fan of rock videos, but young people seem to love them. We were a little skeptical about running the voting in the Soviet Union, because we were worried the Soviet teenagers wouldn't know the difference between Jesse Jackson, Michael Jackson or Andrew Jackson. So we convinced the Soviet TV network to run an hour of continuous videos once a week for 4 weeks. We included a post office address which they could mail their choices.

We expected to get a few hundred votes. We received 5 million. That is right, 5 million votes. The Moscow Post Office wasn't exactly overjoyed with our program. Judging from the tone of the voice on the other end of the phone, you would have thought the Cuban missile crisis was about to be obscured in history by the rock video votes crisis. We ended up actually renting an airplane hangar to store all the ballots.

It wasn't external pressure that forced the Soviet Government to change, it was an internal movement, an insatiable yearning for the things represented in those videos. For freedom of expression, for material wealth and prosperity, for everything from Pepsi to perfume, yes, to Pontiacs.

The quicker we can promote trade of these products, the stronger the ties we can bind between our two countries, and especially between our young people. These ties will sustain the Soviets as they walk what is going to be a very long and a very bumpy road. Those ties of trade will make sure that they never turn back.

Again, I want to thank the committee for allowing me to testify. Thank you.

Chairman ROSTENKOWSKI. Thank you, Mr. Kendall.

[The statement of Mr. Kendall follows:]

Statement of Donald M. Kendall
Chairman, American Committee on U.S.-Soviet Relations
and
Chairman, Executive Committee, PepsiCo, Inc.

I want to thank Chairman Dan Rostenkowski for holding these hearings. I am here on behalf of the American Committee on U.S.-Soviet Relations ... and as a private citizen with over three decades of experience selling Pepsi to the Soviets and Eastern Europeans.

I want to briefly explain my company's experience with the Eastern Bloc, because I think it has implications for overall American policy.

Pepsi has a long history of selling soft drinks in the Eastern Bloc. Ironically, the impetus for our aggressive involvement was a decision made here in Washington almost fifty years ago.

The Japanese had just invaded Pearl Harbor, and Army Chief of Staff George C. Marshall wanted a symbol of home that our soldiers could carry with them to the battlefields of Western Europe.

Unfortunately for Pepsi, General Marshall didn't choose to give soldiers an Irving Berlin album or a Carol Lombard picture. He chose to have each soldier take along soft drinks made by our major competitor.

In this instance, necessity really was the mother of invention. Coke's lead in the Western European market grew out of that World War II experience. It forced us at Pepsi to do something that most American companies at the time considered impractical or downright foolhardy: figure out a way to sell our products in Eastern Europe.

Our first breakthrough occurred after the famous "Kitchen Debate" at the American National Exhibition in Moscow in 1959. With the help of then-Vice President Richard Nixon, I convinced Soviet Premier Nikita Khrushchev to take a sip of Pepsi. I did it by asking Mr. Khrushchev which Pepsi would taste better; one made with water from Moscow, or one made with water from Manhattan. The committee members can guess which soft drink Mr. Khrushchev chose. At the time, our advertising slogan was "Be Sociable, Have A Pepsi." Front pages of newspapers around the world showed Khrushchev drinking his Pepsi with the headline: "Khrushchev Learns To Be Sociable."

It took fifteen years, but we eventually capitalized on that contact, when the first Pepsi plant was built in the U.S.S.R. in 1974. Since then, we have worked to expand our business within the U.S.S.R. and all of Eastern Europe.

Today, there are 39 plants which bottle Pepsi products across Eastern Europe. Sixty-five-million cases of Pepsi products are sold there a year, and we hold the lead market share in every country but two: East Germany and Albania.

In the Soviet Union alone, there are another 24 plants, stretching across nine of the country's eleven time zones. We are about to sign an agreement to build another 28 plants. When those plants are operating, we will be selling as much Pepsi in the U.S.S.R. as we were in the entire United States the year I first joined the company.

In May 1988, we became the first purchaser of commercial airtime on Soviet television, running a Michael Jackson commercial. Pepsi-Cola was also the first company to air a commercial in the United States that was produced entirely in the Soviet Union.

Pepsi-Cola is not the only PepsiCo company with an expanding Eastern Bloc presence. Pizza Hut, one of our restaurant divisions, is preparing to open two restaurants in Moscow this spring. One will be located on Gorky Street, just a few blocks from the Kremlin. When President Gorbachev and his aides tire of those late night discussions about Glasnost, they can order out for a tasty reminder of the real benefits of freedom and free enterprise.

We have learned a lot in three decades of dealing with Eastern Bloc countries and consumers. Three lessons stand out.

We have learned to be patient. Negotiations take time and it takes years to show a profit. Yet the potential is enormous. Consider that the Soviet Union has 289 million potential soft drink lovers. Yet today, even with 24 plants, we only sell the same amount of soft drinks in that entire country as we sell in the State of Oklahoma. You understand why we believe it is worth taking the long view.

We've also learned to be creative. Like all American companies, we were faced with the challenge of how to remove the money we earn from Eastern Bloc countries where currencies can't be converted. We solved this problem by trading Pepsi concentrate for the right to supply wines from Hungary, Bulgaria and Rumania, and for Stolichnaya vodka from the Soviet Union.

It's important to remember that we just sell the Soviets concentrate. They take care of the the sugar, water, glass, and labels. They handle production, sales and distribution. This system employs literally thousands of Soviet citizens and teaches many Soviet entrepreneurs about the basic principles of a successful business operation. It's hard to believe, but two years ago, the Soviet companies won our international quality control award. This is proof of the strides that can be made in the Soviet economy.

Finally, we learned that we had to proceed with little or no help from our own government. For the past three decades, American trade policy has been subservient to foreign policy, to the detriment of everyone.

We've seen three decades of grain embargoes and soybean restrictions, export controls and pipeline sanctions, tariffs on Soviet imports and bans on American exports.

Have these restrictions made a difference? I don't think they have in the Soviet Union. The current changes are more a result of economic distress and the resulting internal political pressure, than any tariffs or boycotts that we have applied.

Here, however, the restrictions have had an impact. They've made it tougher for us to gain a foothold in Eastern Europe ... and given an unfair and unnecessary advantage to our foreign competitors.

Now, at long last, the cold war is thawing. It appears we are finally ready to make trade policy an equal partner of foreign policy.

I believe this will be healthy, not just for American business, but for Eastern Bloc consumers and world politics as well. I hope the members of this Committee will follow this philosophy as they debate trade policy in the coming months.

I recommend four specific actions, and one inaction, which I believe should be undertaken immediately. Three of these changes were proposed by the President at the Malta Summit last month.

The first reform concerns Jackson-Vanik. The President and major Jewish organizations have supported waiving the amendment because of the improved Soviet policies toward Jewish emigration. I say go a step further and repeal it altogether.

In my opinion, Jackson-Vanik never accomplished its purpose. Soviet emigration policy toward Jewish citizens remained unchanged in spite of Jackson-Vanik. In 1972, the year the amendment was passed, Jewish emigration from the Soviet Union totalled almost 35,000. In 1985, the year President Gorbachev came to power, it was slightly more than 1,000. These numbers offer eloquent testimony that Jackson-Vanik had no impact on Soviet behavior.

Now, however, in response to internal political changes, Soviet emigration policy has loosened, and Soviet Jews are leaving the country in record numbers. We should respond by repealing the amendment.

Only complete repeal can give American business the certainty to move ahead and explore creative methods of countertrade. With a waiver, there's always the uncertainty that exorbitant tariffs could be slapped back on. This makes business planning difficult.

Once you repeal Jackson-Vanik, you clear the way for a trade agreement, which leads to my second suggested reform, which is to give the Soviets Most Favored Nation Trade Status, or MFN.

Critics say MFN won't matter. They argue that the ruble can't be converted. So our companies have to turn to barter. They say the Soviets don't have anything our consumers want.

I say these critics underestimate the creativity of the "good ole" Yankee entrepreneur.

I admit, there's not a lot of room left in the vodka export business, but I do believe that with the lower tariffs that go with MFN status, and without Jackson-Vanik, American companies are going to figure out some creative ways to get money out of the Soviet Union.

I would also grant MFN status to Bulgaria, Czechoslovakia, East Germany and Rumania, all of which do not enjoy it now.

I've long favored MFN status for these countries ... because I've always believed that the stiff winds of free enterprise can help knock down even the strongest totalitarian wall. Today ... as these nations experiment with free markets and free elections ... the positive impact of trade has never been greater.

As part of the trade agreement, I suggest we include a provision that would allow American companies that have earned rubles from Soviet ventures to convert their profits to western currency. The "repatriation protection" would be available up to the amount of capital invested by the U.S. company. This will reduce risk and guarantee American investors that they can take their money out. The Soviets have provided such protection in recent agreements with both West Germany and Finland.

That's the third reform. The fourth change I support would be to allow the Soviet Union to become an observer at the General Agreement On Trade and Tariffs (GATT).

As you know, far better than I, the GATT talks have a tendency to go on and on and on.

Given that these talks are often frustrating, you might argue that letting the Soviets sit in on them is sufficient punishment for forty years of adhering to socialist doctrine.

But I think the Soviets would learn something. I do believe Soviet inclusion is consistent with the original purpose of GATT that was established at Bretton Woods four decades ago, to promote international economic vitality and reduce political tensions.

Finally, I have a fifth recommendation, which as I said, is not really an action, but a call for inaction. I urge you to take H.R. 2366, the SLEPAK Principles Act, and relegate it to the ash bin of unwise legislation. The SLEPAK Principles would require U.S. firms that do business in the Soviet Union to adhere to a specific code of conduct. The bill holds the Soviets to a set of different standards at a time when that country's example is making change possible throughout the rest of Eastern Europe. It is at most a nuisance, but not a nuisance that would be endured by our competitors in Japan or Western Europe. I am pleased to see that no members of this Committee have sponsored this legislation.

So those are the five changes we ought to make right away. Repeal Jackson Vanik, grant most favored nation trade status to the Soviet Union and other Eastern Bloc nations, provide basic investment protection to American companies doing business in the Soviet Union, allow the Soviets to observe GATT, and bury the SLEPAK proposal.

We should do all these things, and do them quickly.

I know there's a lot of talk right now about what we in America can do to promote the changes in the Eastern Bloc countries.

There is debate as to who, if anyone, will play the role my friend George Kennan played forty years ago, by providing a coherent vision for the post-Cold War Europe. In some quarters, I even hear calls for a Second American Marshall Plan, this one for Eastern Europe.

I think we have to keep something in mind. No one has experience walking the road from a state-based socialism to a market-based economy. The Eastern Bloc nations are the first to trod this path, and they're going to have walk it themselves. We should not be arrogant enough to believe that we have the answers to their problems.

While I'm not much for grandiose strategies, I do believe that if we are truly worried about Glasnost's future, if we don't want the Soviets and their neighbors to walk backwards, the one thing we must do is increase trade and joint ventures, and do it quickly.

One story should illustrate why.

Last year, Pepsi helped sponsor something called the World Music Video Awards. Teenagers voted for their favorite rock videos. The event ran in scores of countries, including the Soviet Union.

We were a little skeptical about running the voting there, because we were worried that Soviet teenagers wouldn't know the difference between Michael Jackson, Jesse Jackson or Andrew Jackson.

So we convinced the Soviet TV network to run an hour of continuous rock videos, once a week, for four weeks. We didn't include any Pepsi advertising, just a post office box address to which they could mail their choices. We expected to get a couple of votes. We received five million.

Our phones immediately rang at Pepsi's Moscow headquarters. It was the post office. Judging from the tone of voice at the other end of the phone, we thought the Cuban Missile Crisis was about to be displaced in history by the Rock Video Votes Crisis.

The Post Office told us to get the five million ballots out of there, immediately. Of course, the problem was our Moscow headquarters is about the size of a freshman Congressman's office. So we actually had to rent an airplane hangar to store all the ballots.

I didn't come here to make a pitch for rock videos. But to me that little incident underscores an important point.

It wasn't external pressure that forced the Soviet Government to change. It was an internal movement, an insatiable yearning, for the things represented in those videos. For freedom of expression, material wealth and prosperity, for everything from Pepsi to perfume to Pontiacs.

The quicker we promote trade, the stronger the ties that will bind our two nations together. Those ties can help sustain the Soviets as they walk what is going to be a very long and bumpy road. But those ties of trade will make sure that they never turn back.

Again, I thank the Committee for allowing me to testify.

Chairman ROSTENKOWSKI. Mr. Murphy.

STATEMENT OF JOHN J. MURPHY, MEMBER, BOARD OF DIRECTORS, U.S. CHAMBER OF COMMERCE, AND CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, DRESSER INDUSTRIES, DALLAS, TX

Mr. MURPHY. Thank you, Mr. Chairman.

I am John Murphy, chairman of Dresser Industries of Dallas, TX.

Our prepared statement on behalf of the U.S. Chamber of Commerce has already been submitted. I would like to take a few minutes to summarize those points.

Chairman ROSTENKOWSKI. Your entire statement will be made part of the record.

Mr. MURPHY. Certainly the economic and political changes occurring within the Soviet Union and Eastern Europe represent in our view, probably the greatest single economic and business opportunity for American industry since the rebuilding of Western Europe and Japan after World War II. Not since the late 1940's have we seen such an enormous demand for both industrial and consumer products.

We can also predict with certainty that the benefits of this opportunity will flow to those nations and those private organizations within those nations that move quickly to take advantage of these opportunities.

Unfortunately for U.S. business, our competitors in Europe are substantially ahead of us at this point in time, for two basic reasons.

First, while in the early 1980's the United States placed foreign policy export sanctions on countries in the region, reduced the size of the foreign commercial service there, decreased our export financing programs in Eastern Europe to virtually zero, or European and Japanese competitors filled the vacuum very nicely and established themselves as reliable and competitive suppliers of products and technology.

The second reason is that the governments of many European countries have recognized the significance of the changes taking place, particularly in the Soviet Union, much sooner than we have.

During the past several years, these governments have moved aggressively to negotiate, sign, and implement trade treaties, tax treaties and other government-to-government agreements that facilitate two-way trade.

At this point in time, the competitive playing field is severely tilted in favor of our European competitors. It is not too late, however, provided both the Congress and the administration move promptly to level the field with Europe.

On a more positive note, I can assure you, based on personal experience in business dealings with the Soviets and the Eastern Europeans during the last 20 years that American products and services are still perceived throughout Eastern Europe to be the finest in the world. I have witnessed an incredibly strong desire, particularly on the part of the Soviets, to do business with the United States—a desire that we seldom find in most other parts of the world today. They also have an absolute fascination with American technical and business management know-how.

In many ways, it is our economic and business system that is the model for what they are now attempting to accomplish. I predict that, if all other factors are equal, the American economy will be the big winner in these opportunities.

The formal presentation which has been distributed to you contains six areas for consideration for congressional and administration actions. These are, one, the normalization of United States trade tariff relations with the Soviet Union and other non-most-favored-nation countries in Eastern Europe; second, that a competitive, not an aggressive but a competitive, Eximbank credit policy to assist exporters against our European competitors; third, OPIC investment guarantees to support United States companies with joint ventures and subsidiaries in Eastern Europe and the Soviet Union; fourth, decontrol of United States exports of nonstrategic goods; fifth, normalization of United States visa policies, so that we can facilitate the travel of Soviet managers to the United States; and, six, funding for technical and economic assistance programs to teach market economics and private enterprise in Eastern Europe.

I recently had the opportunity to discuss these opportunities with the CEO of one of the largest East European companies. He happens to be based in the United Kingdom. I asked him how he and his counterparts in other European firms viewed changes taking place in Eastern Europe and the Soviet Union. I believe you will find his answer to be very interesting, and I quote, "We consider the opening of these countries as the greatest marketing and investment opportunity we have had since the opening of the Americas centuries ago. We are proceeding accordingly."

Members of Congress, we desperately need your help. Only you and the administration can provide American industry with a comprehensive U.S. Government policy that will give us an equal footing with our foreign competitors. We can and will compete very, very effectively. We are not concerned about competing. We just want the opportunity to do so.

Thank you for your consideration.

[The statement of Mr. Murphy follows; along with a supplemental statement from the U.S. Chamber of Commerce:]

STATEMENT
on
U.S. TRADE RELATIONSHIPS WITH THE SOVIET UNION
AND EASTERN EUROPE
before the
COMMITTEE ON WAYS AND MEANS
of the
U.S. HOUSE OF REPRESENTATIVES
for the
U.S. CHAMBER OF COMMERCE
by
John J. Murphy
January 30, 1990

Mr. Chairman, on behalf of the U.S. Chamber of Commerce, I would like to thank you for the opportunity to testify today on the U.S.'s evolving trade and economic relations with the Soviet Union and Eastern Europe. I am John J. Murphy, Chairman, President, and Chief Executive Officer of Dresser Industries. I also serve on the Board of Directors of the Chamber, and it is in this capacity in which I am now testifying.

There are few issues facing the U.S. today of a more critical nature than those challenges posed by developments in the Soviet Union and Eastern Europe. As remarkable a year as it was, 1989 represents only the beginning of what will be a long and arduous process of political and economic change in this region.

If the U.S. is to be a player in this process, then it must be prepared to act in a thoughtful and comprehensive manner. The piecemeal policies and "light-switch" diplomacy of the past must be pushed aside in favor of a comprehensive and long-term policy toward the Soviet Union and the countries of Eastern Europe.

What perhaps is most encouraging about the current state of affairs in Eastern Europe is that the U.S. is now witnessing a convergence of its foreign policy, security and economic interests. Clearly, U.S. policies in these areas should complement each other with the aim of furthering economic and political reform in the individual countries of Eastern Europe and the Soviet Union.

In order to achieve this objective, it is critical that the U.S. be prepared to engage these countries in all aspects of a normal relationship, including the economic sphere. With respect to U.S. economic relations, there is no better means of engagement than through an active trade and investment policy.

While the Chamber realizes that most-favored-nation (MFN) tariff treatment and bilateral trade agreements are the focus of these hearings, it believes that it is important to touch on all aspects of the U.S.'s economic relationship with Eastern Europe. Consequently, my testimony will also focus on such issues as U.S. export control policy, U.S. visa requirements relative to Soviet and Eastern European business officials, U.S. attitudes on American joint venture involvement in the region, and the technical economic development needs of the region.

On the issue of MFN, if there were ever any doubt that the time was ripe to normalize our trade relations with the Soviets and the remaining non-MFN countries of Eastern Europe, clearly it is now time to put these doubts behind us. It is time for the U.S. to move beyond passivity and become aggressive on the trade front as have its Western European and Asian competitors. Failure to do so may place U.S. companies at such a competitive disadvantage in the future as to impede U.S. business for years to come.

The Chamber was delighted with the President's announcement in December of his readiness to begin negotiations early in 1990 on a trade agreement with the Soviet Union. We urge the Administration to move forward with the other countries in the region in recognition of the tremendous changes that have already occurred. Failure to do so would exhibit an insensitivity on the part of the U.S. to the fact that others have moved farther and faster in the field of political and economic reform than the Soviets.

Obviously, this is by no means a simple task, and it will take a great deal of resources on the part of the Administration. Quite frankly, the Chamber has some concerns that manpower resources in critical governmental agencies have not always kept up with the U.S.'s rhetorical desire to engage the Soviets and the Eastern Europeans in a normal trade relationship. As such, there clearly is a need for greater Presidential direction at the Cabinet and sub-Cabinet level.

Normalized tariff relations are not going to be the panacea for U.S. trade and investment interests in Eastern Europe. Even with MFN tariff treatment, U.S. firms will be competitively disadvantaged compared to their trading competitors in Western Europe and Asia in such areas as export financing and investment guarantees unless the U.S. also moves ahead with its policies and programs in these areas.

At present, the U.S. Export-Import Bank (Eximbank) is doing business in Hungary and we expect the Eximbank to be open for business in Poland in the very near future. In addition to Poland and Hungary, we strongly urge the Eximbank to begin steps to develop programs with the other countries of Eastern Europe and the Soviet Union, so that Eximbank financing becomes effective immediately following President Bush's Jackson-Vanik waiver determination for those countries.

Congress must also be prepared to remove the legislative constraints it placed on Eximbank lending to the Soviet Union back in the early 1970s. Specifically, I am referring to the Stevenson and Byrd amendments to the Export-Import Bank Act of 1974, which establish limits on overall lending and limits and prohibitions on lending for fossil fuel projects, respectively. These amendments should be repealed now as a signal of the seriousness of Congress in normalizing U.S. trade relations with the Soviets.

Similarly, at present, the U.S. Overseas Private Investment Corporation (OPIC) is authorized to provide investment guarantees and financing only to U.S. investments in Hungary and Poland. It is critical that OPIC programs also be extended to other countries in the region if the U.S. is going to be a serious investment partner in these countries. Without such programs, American companies with investment interests in the region will automatically look to Western Europe to source such investments in order to take advantage of investment guarantees and credits.

It is critical that the U.S. government develop a well-defined and public policy relative to U.S. investment in Eastern Europe and in the Soviet Union and that all government agencies act in good faith to implement this policy. At present, there are widely differing views and responses within the Administration ranging from strong support to not-so-subtle opposition to U.S. investment. This is particularly true as it relates to U.S. investment in the Soviet Union and the technology transfers that are associated with such investment.

A related area that demands attention is U.S. emigration policy for admitting Soviet managers and technicians for corporate orientation and training programs. For all intents and purposes, the B-1 visa, which is the normal business visa, is denied Soviet citizens, and, therefore, American companies wishing to bring Soviet managers to the U.S. for training programs must go through the often lengthy process of obtaining an H-3 trainee visa.

The other type of visa available for Soviet managers is the L-1 intracompany transfer visa. However, for reasons of reciprocity, there is a quota on the number of L-1 visas granted at any one time to Soviet managers. This has resulted in a situation whereby many U.S. companies have been unable to bring Soviet managers to this country due to quota limitations. With the conclusion of more joint ventures and the resulting intracompany transfer requirements, the situation will become even more exacerbated and must be dealt with by the U.S. and Soviet governments.

In regard to technology transfer, the Chamber is encouraged by developments within the Coordinating Committee on Multilateral Export Controls (COCOM) aimed at liberalizing export controls to Eastern Europe. However, if the U.S. really wants to help these countries develop into viable market economies, then it has to be prepared to make major changes in its national controls, not only in such areas as telecommunications, computer technology and machine tools, but across the board.

One thing is clear: if the U.S. fails to exercise leadership in COCOM, it will encourage unilateral actions by individual COCOM countries, undermining both U.S. security and commercial interests in the region. In this respect, it is critical that the U.S. develop a well-defined and transparent national export control policy. As experience has indicated, a U.S. export control policy that retains maximum discretion at the licensing officer level ensures there will be no "real" changes in practice.

The Administration and Congress should also be prepared to examine anew U.S. import laws relative to the countries of Eastern Europe. In the Trade Act of 1974, Congress included a special provision, Section 406, to deal with surges of nonmarket economy imports that might disrupt the U.S. market. Congress also mandated that safeguards against market disruption be included in trade agreements negotiated with these countries.

In reality, Section 406 has never functioned as an effective remedy for injurious nonmarket economy imports. Moreover, U.S. dumping laws relative to nonmarket economy imports have consistently proven to be cumbersome and unpredictable. As the countries of Eastern Europe move in the direction of market economies, the U.S. Chamber believes the time is now ripe to review these import laws with the goal of normalizing this aspect of our trade relationship with these countries.

Finally, I would like to talk briefly on the technical economic needs of the region required to hasten the movement toward market economies. Last year Congress enacted legislation to authorize funding for technical assistance programs to support the Polish and Hungarian private sectors. The funds are to be used in such areas as banking reform, private sector joint ventures, and management training.

The Chamber applauds these developments as it believes that such assistance is critical for supporting the private sectors in these countries. With the rapid development of economic reform in other Eastern European countries, it is not too early to begin considering similar technical assistance programs with these other countries. We respectively urge Congress to consider this matter at an early date. Thank you.

SUPPLEMENTAL STATEMENT

STATEMENT
on
FOREIGN INVESTMENT IN THE U.S.
for submission to the
HOUSE COMMITTEE ON WAYS AND MEANS
for the
U.S. CHAMBER OF COMMERCE
by
David R. Burton*
January 31, 1990

The U.S. Chamber of Commerce is pleased to provide its views on the taxation of foreign investment in the U.S. The Chamber presented its views on East-West trade and EC 1992 in earlier testimony.

U.S. Tax Policy Toward Foreign Investment

The press release announcing the hearings on the taxation of foreign investment in the U.S. emphasized that current U.S. tax policy was developed at a time when the amount of foreign investment in the U.S. was significantly smaller. It also emphasized that the U.S. was then a net creditor nation and a net capital exporter.

The Chamber believes that a review of current tax policy toward foreign investment in the U.S. in light of these economic and trade trends is appropriate and desirable. As an increasing number of foreign corporations acquire assets and build factories in the U.S., some alarmists contend that the U.S. is losing control of its economic destiny. Such concern is exaggerated and potentially harmful to our economy. We should not resent or resist foreign investment in this country. To the contrary, we should welcome it.

The Chamber believes that the tax law should not serve to impede the flow of foreign capital to this nation. In the increasingly complex and interwoven international marketplace, competition for investment capital is growing more intense. Every dollar of foreign investment in the U.S. could have gone elsewhere. Every dollar invested in the U.S. improves the health of our economy and creates countless opportunities for Americans.

This is not to say that the U.S. should not be concerned about its trade deficit. To the extent that other nations enjoy virtually unlimited access to invest or sell in our market but deny us equal access to theirs, we have every right to demand reciprocity. Indeed, the Chamber was a strong supporter of the recent trade law with its "Super 301" enforcement mechanism. The underlying premise of U.S. policy is not and should not be to close U.S. markets to foreigners but to open foreign markets to U.S. businesses.

American-owned businesses operate in an increasingly globalized economy. U.S. companies set up operations overseas for a multitude of reasons including such factors as being close to the local market and better access to foreign transportation and distribution systems. In essence, these U.S. companies set up operations overseas to assure that their products remain competitive in world markets.

Foreign-based companies set up operations or purchase facilities in the U.S. for similar reasons. They are investing in the U.S. because of the strengths of the American economy and the opportunities that the U.S. market offers. The U.S. offers foreign investors a stable business climate and labor pool.

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*Manager, Tax Policy Center

Growing world trade and increasing transnational investment is good for both the U.S. and its trading partners. Trade and foreign investment is not a zero-sum game but, to the contrary, is beneficial to both economies.

Instead of focusing on ways to restrict capital flows from abroad, the U.S. should begin an evaluation of those tax laws that impede the free flow of capital and investment. Restriction on foreign investment flows to the U.S. are another form of protectionism. Restrictive policies are likely to result in retaliation and a world trading regime that will harm American-owned businesses and the U.S. work force as well as those of our trading partners.

Foreign Investment in the U.S.

The U.S. media has trumpeted stories of foreign persons and companies investing billions of dollars in U.S. businesses, securities, and real estate and farmland. This was particularly the situation regarding news reports in 1989 of Japanese investors purchasing an interest in Rockefeller Center Group.

These news reports would make one think that the U.S. has lost control of its economy. But this is hardly the case. According to the Joint Committee on Taxation, the total amount of foreign-owned assets in the U.S. was approximately $1.8 trillion at the end of 1988. The largest foreign investor in the U.S. is the European Community, accounting for 59 percent of all foreign investment in the U.S. The United Kingdom alone accounts for 31 percent of all investment in the U.S. Canada accounts for 8.3 percent while the Japanese provide 16.2 percent of the foreign investment dollars. In a broader perspective, the amount of foreign-owned assets represents approximately 6% of all privately held assets in the U.S. Thus, foreign investors control only a small fraction of U.S. wealth.

The U.S. is not losing a sense of national sovereignty due to the growth of foreign investment in this country. In testimony on this point before the Senate in March 1988, Elliott Richardson stated, "like U.S. investors, foreigners must comply with all the laws on the books, the Securities and Exchange Commission reporting requirements, and antitrust laws. Then there are special restrictions for foreigners in certain key sectors such as radio and television, coastal and inland shipping, air transport and nuclear power. The Defense Department has a comprehensive set of regulations which limit or bar foreign ownership of companies that have government contracts involving classified information."

Foreign investment in the U.S. often brings new technology and management techniques to the domestic market that can serve to enhance the economic competitiveness of U.S. business.

There are a number of recent tax provisions that will have an adverse effect on foreign investment in the U.S. and needlessly impede the free flow of capital. These provisions deserve serious reconsideration.

Legislative Override of U.S. Tax Treaties

Since the passage of the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988, significant measures that serve to override tax treaties between the U.S. and other nations have been enacted into law. This is a major problem for U.S. business, particularly since it is coming at a time when there is increased pressure on U.S. corporations to improve their competitiveness through the sale of products and services on a global basis.

This unwillingness to honor our international treaty obligations will have two effects. First, it will make foreign governments less willing to enter into mutually beneficial treaty arrangements and second, it will invite retaliation by foreign countries. An appropriate component of any review of current international tax policy must take into account the possibility of foreign governments retaliating against U.S. business interests in those countries as a direct result of legislation overriding existing treaty obligations and on the willingness of foreign governments to enter into agreements in the first place.

The Chamber is a strong supporter of the U.S. treaty network and urges Congress to avoid any treaty overrides in the future. The U.S. has traditionally been a strong supporter of tax treaties. Governments signing tax treaties benefit from the increasing economic activity between the two treaty signatories, and from information exchange, which provides a mechanism for fair resolution of double taxation matters. In this way, tax treaties provide a framework for resolving disputes in an orderly fashion based on norms of international law. Treaties provide the business communities of both nations with commercial stability and certainty, which are key ingredients in staying competitive in an increasingly globalized marketplace.

Further efforts to enact legislation overriding tax treaties occurred during the fiscal 1990 budget reconciliation debate. The Omnibus Budget Reconciliation Act of 1989 includes several provisions affecting the taxation of U.S. firms operating abroad and foreign firms operating in the U.S., including a measure designed to address so-called "earnings stripping" by a foreign parent of a U.S. affiliate and a provision requiring increased information reporting by U.S. subsidiaries and branches of foreign-based corporations. Another proposal included in the House reconciliation bill, but later dropped by the House-Senate conference committee, would have imposed a capital gains tax on the disposition of stock held by certain foreign shareholders in U.S. companies.

The Chamber vigorously opposed these proposals due to their potential for impeding free trade and investment. The U.S. economy benefits from foreign investment in the U.S., and it also benefits from investment by U.S. business in foreign countries. The free flow of capital in this manner creates prosperity and employment. It is the Chamber's view that the tax treaty structure between the U.S. and the nation's trading partners should be protected and not undercut by legislation that results in treaty overrides.

The 1989 Budget Reconciliation Act and "Earnings Stripping"

The 1989 Budget Reconciliation Act (the 1989 Act) places limits on a corporate taxpayer's deduction for interest paid to related parties for certain transactions. The primary impact of the measure is to limit the deduction for interest paid by a U.S. subsidiary to a related foreign corporation, i.e., a foreign parent. To the extent that the U.S. subsidiary has what is considered excess interest expense for a taxable year, and the ratio of debt to equity of that firm for the year exceeds 1.5 to 1, the subsidiary would find its interest deduction limited by this provision. It is clear that this provision could negatively affect start-up companies or other companies that have a legitimate operating loss (or low profit) in any given year. Thus, the impact of the proposal is much broader than advertised.

This measure will act as a substantial disincentive to desirable investment by foreign corporations in the U.S. and, therefore, reduce U.S. employment and economic growth.

The House-Senate conference report for the 1989 Budget Reconciliation Act includes 2 1/2 pages of rationale as to why this provision should not be considered to be violative of current U.S. tax treaties. Nevertheless, the conferees found it important to state that they are aware of the complexity of the legal issues involved in this matter and the possible evolution of international standards for identifying thin capitalization. The conferees have therefore granted authority to the Department of Treasury to make appropriate adjustment, by regulation to the definitions applicable to debt-equity, net interest expense, and adjusted taxable income and so forth.

The Chamber has serious concerns that the "earnings stripping" provision violates long-standing principles of U.S. tax policy reflected in tax treaties with other major trading nations and, thus, the measure is likely to result in foreign governments enacting measures to retaliate against the subsidiaries of U.S. companies investing abroad.

Increased Information Reporting and Penalty Rules

If a corporation is conducting a trade or business in the U.S. and it is controlled by a foreign person, that corporation must file an information return (under Section 6038A) regarding transactions with the related foreign person.

Under the 1989 Act, the reporting requirements of Section 6038A are expanded to cover corporations that have at least one 25 percent foreign shareholder. The 1989 Act also requires the maintenance of books and records in a location, manner and to the extent prescribed by regulation which are considered appropriate for review of transactions with related persons. Although records would normally be required to be maintained in the U.S., the Department of Treasury would be permitted to allow records to be maintained outside the U.S. where it is satisfied that such records would be submitted to the IRS "promptly upon request." Moreover, the provision increases the penalties for failure to meet the requirements of Section 6038A, and it imposes substantial enforcement rules regarding such information requests.

The conference agreement for the 1989 Act suggests that this recordkeeping requirement is not violative of tax treaties in general or of restrictions imposed by information-exchange provisions of tax treaties. Despite this position, the Chamber believes that proposals of this type are unnecessarily intrusive and burdensome on foreign investors in the U.S. If there is compelling rationale for adoption of such a proposal, a more prudent approach would have been for the matter to be addressed by treaty negotiations between the U.S. and foreign governments.

Disposition of Stock in Domestic Corporations by 10 Percent Foreign Shareholders

The House-Senate conferees did not include an earlier House proposal in the final 1989 Budget Reconciliation Act, which would have otherwise subjected certain foreign investors to a capital gains tax in the U.S. on the disposition of stock they owned in a U.S. corporation. The proposal would have applied to a foreign person owning more than 10 percent of the stock in that U.S. corporation.

The Chamber fears that a proposal of this type only invites retaliation by foreign countries against investment by U.S. residents overseas. In particular, the capital gains proposal is inconsistent with traditional notions of international taxation and violates existing income tax treaties with major trading partners. It is well settled tax policy that gains on stock sales should generally be taxed only by the country of residence, not by the country of source. The Chamber strongly recommends rejection of similar proposals in the future.

Withholding Tax on Interest Paid to Foreign Investors

Prior to 1984, payments of passive income (i.e., interest, dividends and royalties) to foreign persons were subject to a 30 percent withholding tax if the payments were not effectively connected with a U.S. trade or business conducted by the foreign person. Some U.S. tax treaties reduced the withholding tax rate below 30 percent. Congress repealed the 30 percent withholding tax on U.S. portfolio interest paid to foreign investors in 1984. Since then, there have been periodic recommendations for re-imposition of a withholding tax on U.S. portfolio interest to such investors.

The Chamber is opposed to the imposition of withholding taxes on U.S. interest paid to foreign investors for several reasons. First, tax exemption of interest paid to foreigners increases the flow of capital into the U.S., resulting in greater domestic investment, lower interest rates and increased economic growth. Second, a withholding tax on foreign investors' portfolio interest is a barrier to international trade that could be considered similar to the nature of a tariff. Allowing foreigners to freely invest in the U.S. benefits the U.S. by encouraging domestic projects to be undertaken that otherwise could not have been financed and allows the foreign investors to achieve their required rate of return at a lower cost to U.S. companies.

Many foreign countries do not tax interest paid to outside investors. Thus, a U.S. withholding tax on foreign investors will not result in more equitable tax treatment among lenders because foreign lenders will not end up paying U.S. tax on U.S. source income. Instead, they will invest their capital elsewhere.

It is the Chamber's view that imposition of a withholding tax on existing debt would only serve to frustrate the legitimate expectations of foreign investors. Imposition of the tax on only new debt would raise little revenue and result in less overall investment in the U.S.

The Chamber appreciates the opportunity to present its views on these important matters to the Committee and looks forward to working with the Committee as these issues are considered in the future.

Chairman **Rostenkowski**. Thank you, Mr. Murphy.

Mr. Gibbons.

Mr. **Gibbons**. I want to thank both of you for your testimony.

Mr. Kendall, you are right, I really think, with all respect to Mr. Jackson and Mr. Vanik, their amendment just missed the mark and made captives out of a lot of people who could have been free a long time ago had we not enacted that law.

I believe like you said that the real revolution came from the inside of those countries and not from outside pressure. They got sick and tired of listening to one-party rule, the secret policies, and all the snooping and everything else that goes on in those countries and finally just kicked the rascals out.

We have an opportunity now to exploit it. Now I see Japanese and Germans, French, English, and everybody else over there but very few of us. Our laws are still on the books like this. It covers anything other than tourists. That gets old.

You have done business in all those countries, and you certainly know that area a lot better than I would ever know it. How do you do business in those countries? Do you control your own labor force in those countries? How do you work that out, your employees?

Mr. **Kendall**. Thank you, Congressman Gibbons.

With regard to your comments, obviously I totally agree with you..You know what the Japanese and Germans are doing. Everybody is quite aware of the amount of trade they are developing and what their Government is doing to assure the business community has access to the market.

Now you notice that the Japanese have given their first foreign aid to Hungary and Poland; but if you read the fine print of that aid, you will find it is not aid but it is money to buy Japanese products. The Japanese have seen that there is an opportunity there.

I find quite amusing some of the comments that were stated earlier in the hearing about the concern of the Soviets putting people out of business in this country. I would be more concerned about the Japanese putting people out of business than I would the Russians putting people out of business.

I agree with your comment about antidumping laws. The first trade agreement we had with the Soviets before Jackson-Vanik covered that very well, including the dumping provisions.

We have two types of operations with them. We have the franchised operation where local people manage the Pepsi Cola plants and we sell them concentrate. We have helped them build those plants, put in the quality control. We have been holding quality control seminars there for years.

Last year, the Soviets won the quality control award for the international operations. We never thought that would happen in the Soviet Union. We spent a lot of time training them.

In the Pizza Hut operation, we are about to open two Pizza Huts in Moscow, one on Gorky Street. It is a joint venture. We have 49 percent, and the Soviet local organization has 51.

The Soviet people who are going to operate them are being trained now in London in our Pizza Hut operation.

We have reached agreements on accounting. One of the problems in the Soviet Union is how do you count things. You are right. You have to have a lot of negotiating about how you count money. But the biggest thing is to train them, give them an entrepreneur spirit.

The Soviets since 1917 have had highly a centralized economy where the manager in the plant is not a real manager. He simply manufactured the widgets. Somebody else tells him how the supplies are coming and what the price is. So we had to train them.

Mr. **Gibbons**. Thank you.

Chairman **Rostenkowski**. Mr. Pickle.

Mr. **Pickle**. Gentlemen, I think most Members of Congress, as well as this committee, would favor some advancement on the most-favored-approach for Eastern Europe. I think we all think we ought to make some changes.

I think it is interesting to say immediately we ought to repeal Jackson-Vanik. I think in retrospect, Jackson-Vanik probably served a very good purpose at the time. It certainly announced a principle we believe in, human rights. I think that has had its effect.

It may well be that the time has come to restate Jackson-Vanik rather than a mandatory manner. I am not ready to criticize Jackson-Vanik. I think it served its purpose at the time. The problem is, what do we do with Eastern Europe?

I appreciate your testimony. I would like to address this question perhaps to Mr. Murphy more than Mr. Kendall. You say that it is more than just giving most-favored-nation, and I think we all would be inclined to agree, that we ought to make specific changes in the Export-Import Bank. That would be a necessary part of the overall move.

So as we look at the most favored nation, we will have to make those changes. You said Eximbank is made available now only to Hungary and Poland at this time, and you want to expand that to all the European nations. You say the same consideration should be given by OPIC.

Mr. **Murphy**. Yes, sir.

Mr. **Pickle**. I agree.

You said the Stevenson-Byrd amendment damaged American industries by putting specific limits on lending. Why should that be repealed?

Mr. **Murphy**. Those two amendments had very severe limitations, particularly related to energy lending, oil, gas, coal, anything to do with that area. You probably noticed recently the Italian national oil company went to the Soviet Union and concluded a $2 billion deal which included a large amount of Government financing.

That would be impossible for the United States, for any U.S. company to consider that today if it involved any type of Government guarantees or financing.

On the subject of the Eximbank, the issue is not whether we want to offer U.S.-bank financing or guarantees. The issue is whether we will be competitive with the Japanese or German competitors.

If nobody was offering financing, it would not be a problem. The situation we find ourselves in is that our European competitors, English, French, Germans, Italians do have government programs;

the Japanese have similar programs. That is what we want to compete with.

Mr. PICKLE. Then you think we ought to repeal Stevenson-Byrd and repeal these limitations.

Mr. MURPHY. Yes.

Mr. PICKLE. You also point out that our Government should liberalize our export controls. In line with that very point, we should try to make it easier for our businesses to export our technology and other goods. Perhaps that would be a good thing.

You also said at the same time we ought to put the controls by a so-called 406 amendment which kind of protects imports coming to this country, protects our goods. Is there a real danger about section 406, the imports flooding into this country?

Mr. MURPHY. I don't think so, Congressman. I have seen the goods produced in these parts of the world. I know what the qualities are, the characteristics. If you are not driven by a customer base, your products will not be very good.

They will have a very difficult time competing in our country today.

Mr. PICKLE. If we do try to liberalize our export controls, and that would be desirable, at the same time we cannot say we are going to protect goods coming into this country. I don't think there is a danger of flooding goods.

I have been into Russia many times. I don't think they manufacture many things this country wants. They have a long way to catch up, just to get in the ball game.

We should encourage it. As we liberalize export controls, I don't think at the same time we can be protecting imports. We ought to be fair about it.

Mr. MURPHY. Their own internal needs and pentup demands for goods is so great, we don't have to worry about them attempting to flood our own markets. Their first priority is to take care of their own markets. That is where it will go.

Chairman ROSTENKOWSKI. Mr. Schulze.

Mr. SCHULZE. I don't want to get into a debate. I think we want to go in the same direction.

I would like to see a world trading order that is open and free and a level playing field, and everybody is free to sell their products without subsidization anywhere in the world.

But I am really concerned when I hear you saying that their products are not of such quality or caliber that they are accepted in the marketplace of the United States of America, yet the only way to repatriate products are through their own products.

Mr. Kendall just testified that they are doing millions or billions of dollars worth of business. They must be bringing in millions and billions of dollars worth of countertrade. It must be going somewhere.

I may be wrong, but if I am developing factories and plants in the Soviet Union and whatever profits are repatriated, I am bringing back into the United States in the form of goods, whether it is tables, chairs, wine or whatever. Those goods are then purchased by the American people.

I don't know how that is creating—I am sure it creates some jobs, but I don't know whether that is really serving our long-term goals because what we are doing is selling a product in their market and bringing their products over here and selling them in our market.

I realize it is a good way for Pesi-Cola, perhaps, to make money; but if I were sitting trying to design a long-term trade policy which would enhance the United States of America—I have to tell you, that is where I am coming from—as we do that, I want to help the rest of the countries, but I want to provide a good, stable economy with the opportunity for upward mobility to the workers in the United States.

So, I do have some concerns over what you said. I don't want to get into a debate.

First, Mr. Kendall, I don't know whether you totally answered Mr. Gibbons' question, do you have any control over the employees which are hired in the Soviet Union?

Mr. KENDALL. That depends if you have a franchised operation or a joint venture. In our case with Pizza Hut, we have a lot of control over those employees.

Mr. SCHULZE. How about the Pepsi-Cola bottling operation; is that 49-51?

Mr. KENDALL. They are franchised exactly the same as we would have with a bottler in Pennsylvania. We would not have any more control than we would have with a franchised bottler in Pennsylvania.

Mr. SCHULZE. What kind of people own the franchises, the Communist Party, a local bank, a group of citizens?

Mr. KENDALL. There are various organizations in the Soviet Union such as the Ministry of Food. The Ministry of Food in the Ukraine is a franchisee.

Mr. SCHULZE. So it is the state.

Mr. KENDALL. Yes, it is all the state. They have just started going toward a market-oriented economy. If you have been watching recent statements——

Mr. SCHULZE. I have not only watched it, but I have met with the Soviets for the last 15 or 16 years on topics along this line. So I am somewhat aware of it.

You said it is 51–49, with you having the 49. How much control do you have, or do you have no control?

Mr. KENDALL. Yes, we have control. In the joint venture, both sides are supposed to operate. As a matter of fact, one of the people that they were giving us that we did not particularly want we already got rid of.

As I said earlier, those people are now in London being trained to operate it.

Mr. SCHULZE. You also indicated you have to negotiate over the exchange rates and profits, correct?

Mr. KENDALL. A joint venture in the Soviet Union, outside of the fact that you are having a joint venture with a state-owned enterprise, is not any different than a joint venture in any country.

In Mexico, you cannot own over 49 percent. That is true in many countries.

Mr. SCHULZE. Who determines—if your profit is x number of dollars, who determines the type and amount of counter trade and where can you spend those rubles or whatever the currency is?

Mr. **Kendall**. Under the agreement we have, we can take our profits out of the Soviet Union. It so happens in Pizza Hut that we have hard currency stores, as well as local currency stores. They want Pizza Huts all over the Soviet Union.

In addition to that, we have started a program of buying tankers out of the Soviet Union to generate funds for these additional 28 plants. We will probably earn the foreign exchange for those by selling tankers which we are selling on the world market.

Mr. **Schulze**. So you in exchange for the profits are taking from them tankers, oil tankers?

Mr. **Kendall**. Oil tankers.

Mr. **Schulze**. Then you sell the tanker on the world market?

Mr. **Kendall**. Yes, we do.

Mr. **Schulze**. My time is up.

I thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Cardin.

Mr. **Cardin**. Thank you, Mr. Chairman.

I appreciate the testimony from both of you. Clearly, there is a lot we can do in this country to promote better trade between the United States, the Soviet Union and the countries of Eastern Europe.

I want to focus in on what the private sector could do to be more aggressive in this relationship. We know there are obstacles in every country as it relates to trade with the Soviet Union, whether it be Japan or West Germany.

I was recently in Berlin and noticed how aggressive the West Germans are in taking advantage of the new opportunities in East Germany. That is being done in large measure by the private companies that are located in that part of the world.

I was very impressed to hear Pepsi's story about what is happening in Moscow. I wonder whether the U.S. business people are somewhat timid compared to our competitors in Japan, Germany, and other countries in taking advantage of opportunities that now exist as a result of changes in Europe.

Would either of you want to comment?

Mr. **Murphy**. I would like to comment on that, Congressman. We have, speaking for my own company, we have done in the Soviet Union in the last 10 or 12 years probably over $1 billion worth of business, usually quietly but sometimes with a great deal of publicity.

You will recall the pipeline embargo a few years ago. Those were our compressors out of one of our French plants, which was a disaster to say the least, in many ways.

My own views are that American companies in the Soviet Union are as aggressive as anybody else in the world. Our problem in being successful are some of the roadblocks which have been created by past policies, the pipeline embargo, you all know them. That is not the question.

It is not whether we are trying to get the business. We can compete, and they want to do business with us. But it is the uncertainty about what the future governmental policies, what they will be, that is the biggest roadblock we face.

It is not a question of competing on quality or cost. We can do it.

Mr. **Cardin**. How about the other Eastern European countries?

Mr. **Murphy**. They have established themselves as a reliable supplier over the last 10 years. They don't face the same questions we do. But the desire to do business here is incredibly strong.

All we have to do is give them a stable policy under which to do business.

Mr. **Cardin**. In Hungary, it appeared there were opportunities, but the individuals I talked to indicated there is a reluctance by Americans to invest whereas other countries have come in and put their money up.

Mr. **Murphy**. There is a lot of truth in that because of the uncertainty of our policy.

To develop the companies it takes 10 or 15 years. We have had an office in Moscow for 15 years. It was 5 years before we made the first sale.

If U.S. companies are not going to be allowed on a reasonably consistent basis to be there, we will not spend the money.

Mr. **Cardin**. So you believe it is the U.S. policy.

Mr. **Murphy**. It is the uncertainty of the policy.

Mr. **Cardin**. Do other European and Asian nations understand their relationships with these countries?

Mr. **Murphy**. Yes.

Mr. **Cardin**. Mr. Kendall, do you agree?

Mr. **Kendall**. Yes.

Let me give you an example of what happened with U.S. business. I took a group over there in 1971 and 1972 which started the first American trade. Maurice Stans was Secretary of Commerce then.

I set up the U.S.-Soviet Trade and Economic Council, which Mr. Murphy will be the new chairman of. We got all the major American companies going to the Soviet Union.

They opened up offices. Some spent a tremendous amount of money on projects. At that time, estimates were made by Citicorp, General Motors, General Electric Co., I think there were five corporations that made a study of two-way trade. They said in 10 years there could be $50 billion. There was tremendous excitement. A lot of companies went over.

Then we got Jackson-Vanik. They closed their offices and came home. It has been hard to get the companies interested again.

Now you are beginning to see some interest. In our business, we had to finance the equipment. I will never forget the negotiations because at that time, interest rates in the Soviet Union were 3½ percent. We could not borrow money for that.

I told them about our administrative costs, and we added that to the interest and got a deal. I wanted to get American equipment in there. The American suppliers could not get financing from the Government.

So Seitz, the Germans, came up with it. They put the equipment in our first 10 plants. Today Seitz has all the breweries in the Soviet Union.

We had the opportunity to get it. But we have too many people in this country who live in what I call the Marshal plan era. They think the United States still has all the money in the world, that we have all the industrial production, and that we have all the technology in the world and therefore, our economic policy must support whatever our foreign policy goals happen to be at that moment in history.

The last thing we think about is economic policy. People have to realize that economic policy in this country has to become our No. 1 concern because we have a big trade deficit, a big budget deficit.

Unless we recognize that and start to do something about it, we are going to keep going down the tube.

With Japan, our problem with them is that they have a 5-percent cost of capital advantage on us because of our deficit. We have to recognize our first requirement has to be our economic policy because the Japanese and Germans recognized this a long time ago. That is one of the things strangely enough that the Soviets recognize.

One of the highest officials of the Soviet Union told me in a private meeting, "We are a military giant and an economic pigmy." They recognize they will have to compete in the world.

It is about time that we do.

Mr. **Cardin**. Thank you.

Chairman **Rostenkowski**. Mr. Pease.

Mr. **Pease**. Thank you, Mr. Chairman.

Thank you, gentlemen, for your testimony which I found to be excellent.

Mr. Kendall, we keep showing our fascination for the details of your operations in the Soviet Union. Let me pursue it a little further.

Regarding the 51 percent Soviet ownership in your two Pizza Hut operations in Moscow, who owns the 51 percent on the Soviet side? Is it a state or Government agency?

Mr. **Kendall**. It is a Moscow group. In the Soviet Union, you can deal with co-ops and have joint ventures; and those, of course, are private.

In our case, we are dealing with a Moscow group controlled by the city of Moscow.

Mr. **Pease**. So you are not dealing with cooperatives in this particular case?

Mr. **Kendall**. No, but we have some cooperatives very interested. Probably the next group we will be dealing with will be a cooperative group.

Mr. **Pease**. Mr. Kendall and Mr. Murphy, I would presume from your own backgrounds and the organizations that you represent that you are in general in favor of free enterprise. Is that a safe statement to make?

Mr. **Murphy**. That makes sense.

Mr. **Kendall**. You are a very good observer.

Mr. **Pease**. I presume you are in favor of democracy?

Mr. **Murphy**. It makes sense.

Mr. **Pease**. Do I gather from your testimony that you do not think it is appropriate to use trade policy as a means of promoting and extending free enterprise and democracy?

Mr. **Kendall**. I recognize where you are coming from.

Mr. **Pease**. Do you recognize where I am trying to get you to go to?

Mr. **Kendall**. But I am not going to follow down that path. I think, as I said earlier, that we have tried to go around and change countries in the world to where it hurts our own country, our own employees.

Mr. Murphy mentioned the pipeline sanctions. Caterpillar had all the business in the Soviet Union. Kamatsu in Japan had very little. We put in the pipeline sanctions and they took the business to Japan. The Soviets found out that they could not only build the pumps but they are now a world competitor and the pipeline was finished on time.

I don't know what we have proved by that policy. Because of Jackson-Vanik, we lose all the bottling equipment from being produced in the United States. The people in Peoria had unemployment after that deal. I don't think those people were very happy by the pipeline sanctions. I don't think our farmers were very happy about the agricultural sanctions. Look what happened there.

We had 78 percent of all the grain imports into the Soviet Union from United States farmers. What happened with Afghanistan and the Carter embargo? They went to Canada, Australia, and Argentina.

As a matter of fact, they are now big investors in Argentina and we lose the grain sale. I don't think that policy is very helpful.

Mr. PEASE. Mr. Murphy, on behalf of the Chamber of Commerce, do you generally agree with the statements just made by Mr. Kendall?

Mr. MURPHY. Yes, I do. Your presumption is that if we can deny them access to our products or markets, we can encourage them to change in other ways. That presumes we have the only source of supply. Unfortunately, that is not true.

Mr. PEASE. Would you two gentlemen individually and at least Mr. Murphy in the case of your organization, follow the same policy of not tying trade to free enterprise or democracies or human rights in relation to, say, South Africa, Cuba, Nicaragua? Do you think it ought to be applied across the board that there be no connection between trade policy and human rights, democracy, free enterprise?

Mr. MURPHY. That is a broad question. I think the effectiveness of trade sanctions has been pretty well documented. Unilateral trade sanctions have proven to be almost totally ineffective. They are only effective when they are done multilaterally, on a broad basis.

We have gotten ourselves into a dilemma of trade sanctions as a political aspirin and that is about all they are.

Mr. KENDALL. Take the South Africa sanctions. The United States companies operating in South Africa probably had the best performance of any company in relation to the employment policies in this country.

What happened as a result of those sanctions? American companies ended up selling because of pressure from universities and state organizations that they were going to sell their stock. So they sold their companies.

Who did they sell to? The Israelis, the Europeans, and to the Japanese. Well now do you think those countries have the same employment practices that the U.S. companies have? We did not help the people we were trying to help. So I think the only time economic sanctions are worth considering is in time of war. We are not at war.

I think it is very foolish for this Congress to ever enact economic sanctions.

Mr. **Pease**. Thank you.

Chairman **Rostenkowski**. Mr. Levin.

Mr. **Levin**. Mr. Kendall, following that up, and I will ask both of you, you said in your testimony that it was not external pressure that forced the Soviet Government to change. You include within that external military pressure? You said it was not external pressure that forced the Soviet Government to change.

Do you exclude all kinds of pressure from outside military otherwise or not?

Mr. **Kendall**. There obviously is a large group in this country who thinks that all the money that we spend on military and the strong build up that we had in military, that that is the reason the Soviets changed.

I don't happen to buy that. I don't believe that. I think the Soviets recognized what was happening when Gorbachev came in. One of the leaders made the statement to me at the time that this occurred that they were economic pygmies and military giants.

I think they recognized the competition of the future is economic competition, not military competition. They had tremendous pressure inside of the Soviet Union because they reached a certain level and could not go any further. There were pressures for things we have in this country. You could go there and find people dancing to American music and dancing in blue jeans. You can buy blue jeans in the black market.

There was pressure in Eastern Europe. I don't think any of the changes in Eastern Europe would have occurred if it had not been for Gorbachev. He let the genie out of the bottle. He told them the Soviet soldiers were not going to move in. Once they were safe to move, they moved at a speed that nobody would have anticipated. I do not think all the money we spent in military in the United States caused the change in Eastern Europe.

Mr. **Pease**. I agree with you about the internal forces. You think all the external pressures were irrelevant?

Mr. **Kendall**. No, I think that the more trade you can get going, the more tourism——

Mr. **Pease**. Do you think all the military pressure was totally irrelevant to the changes that occurred in the Soviet Union?

Mr. **Kendall**. Congressman, you can probably say the fact that we spend so much that we made them spend so much on military and they did not develop the consumer sector, then yes, it had an impact. They did not develop the light industry. They stayed with the heavy industry so I suppose you can say it had some impact.

Mr. **Pease**. It seems to me this may not be an either/or proposition. The changes may have occurred for a number of reasons.

Mr. **Kendall**. I think that is true.

Mr. **Pease**. That affects how one looks at issues including Jackson-Vanik. To simply say all the external pressures were unrelated, you may believe that but it seems to me that it may be an overstatement.

I don't think we need to go that far to ignore the importance of the internal pressures that developed within the Soviet Union.

Let me ask both of you about U.S. governmental policy. Mr. Murphy, you say in your testimony that it is critical there be a well defined U.S. Government policy. At present there are widely differing views and "supposes" within the administration, ranging from strong support to not too subtle opposition.

Mr. Kendall, you indicated your strong views about default in Government policy. Why are we lacking a policy? What is the problem?

Mr. MURPHY. I think there are several parts to that answer. Part is our history of the last 50 years, particularly the last 10 years. As a result of that, we have an even trained group of people in certain administrative departments in Washington, no matter what the intention might be they are still thinking as they did 10, 15 or 20 years ago.

It is very easy to put road blocks in the way to slow it down or stop it. We have had an experience trying to bring Soviets into the United States for management training for a few months. To get them a visa is a nightmare.

Mr. PEASE. Why is that?

Mr. MURPHY. I wish I knew the simple answer. It is ingrained attitudes, practices, that is part of it. That is not all of it. I think the biggest problem on a policy standpoint has been the variability of our policy, the lack of any consistency over any period of time.

Chairman ROSTENKOWSKI. Mrs. Johnson.

Mrs. JOHNSON. Thank you, Mr. Chairman.

Just briefly, a couple of questions.

If we make some of the changes that you are recommending, which in a sense amount to dropping human rights and immigration policies and things like that as conditions of doing business with other nations and, particularly, with the Eastern European nations and U.S.S.R., are there not some things, however, that we should make conditions of trade?

I refer specifically to that aspect of the trade bill that dealt with pricing between market and nonmarket economies. I personally feel, and this gets back to Mr. Schulze's remarks, that we should not be concerned about the entrance of nonmarket economies into a market international trade system unless we can clearly deal with them around the issues of fair pricing, market access, nontariff trade barriers. I think it should be very important to us to set the rules of trade between the United States and these nations in an enlightened way in recognition of the real problems that have developed in the international trading system.

I wonder how you would deal with those issues and, last, kind of in the same context, are you concerned about the EC-1992 process that is resulting in directives that are evermore prescriptive in terms of domestic content, another form of a nontariff barrier?

I think the fair trade issues are issues that must be addressed as we relook at Jackson-Vanik and recognize some of the failures of past policies that you have clearly discussed.

Mr. MURPHY. Well, there are several very important questions there. The whole area of Jackson-Vanik versus that of trade pricing practices are separate issues and need to be dealt with as separate issues.

My concern is that we get all tangled up in the debate on Jackson-Vanik and never know where we are at or get anything resolved. You have a very good point.

What is an adequate and fair price out of an economy such as that? We don't know. A lot of work has to be done. But that is not the reason to hold up the whole negotiating process until we sort that out.

The West Germans recently signed a trade investment agreement with the Soviet Union. It is very definitive. I don't know why we can't take it and copy it. We have the same concerns. They are much closer to them. It has to be done. We have to get to work on it and do it; quit talking about it and get it done.

Mrs. JOHNSON. Any comment, Mr. Kendall?

Mr. KENDALL. I agree with what Mr. Murphy says. We just can't keep negotiating on and on and on. It is like the Cocom agreement, the things that we have restricted.

If you recall, that was started by Mr. Busey then at Texas Instruments. He was the head of a group that came up with a list of leading-edge technology that should not be sold for military purposes.

Richard Perle took that list and expanded it and expanded it and expanded it to things that were not military related at all and stopped all kinds of sales to Eastern Europe, India and the Soviet Union. We end up losing the sales in this country.

As you well know, our other allies end up getting the business.

Mrs. JOHNSON. I appreciate your comment.

My time is up. I look forward in the future to hearing from you on the issue of EC-1992 directives and their impact on the American market.

Chairman ROSTENKOWSKI. Mr. Downey.

Mr. DOWNEY. Thank you, Mr. Chairman. Thank you, Mr. Murphy and Mr. Kendall for your testimony.

I find myself in substantial agreement. I was the one along with Senator Moynihan who offered the waiver to Jackson-Vanik. I think maybe that is not enough. What would you suggest that we do in terms of going beyond the waiver? Do you believe an outright repeal of Jackson-Vanik makes more sense in terms of our ongoing relationship to the Soviet Union and how do you think the Soviets would react to a simple waiver as opposed to outright repeal?

Mr. KENDALL. The Soviets would, obviously, react better to a repeal than a waiver, but I don't think that is the important thing. Action on Jackson-Vanik will be well received.

Those of you who have traveled there know the first time you get into a discussion with a Russian, that is the first thing they run up the flagpole and it has been for years.

The resulting trade that will flow as a result of Jackson-Vanik repeal, Soviet goods coming to this country, is not a big item. It is a symbol. But the repeal would tell American companies that we are not going to play politics anymore, boy, go ahead and get your trade.

George Shultz said one time, I wonder if he forgot when he became Secretary of State, you cannot have light switch diplomacy in economic relations. You cannot shut them on and off because most of them are long-range projects. You look at what we started with in the Soviet Union with 10 plants, you would have been crazy if you thought that was all you would get.

Now we have 24 plants. We are going to get 28 more plants. The business is growing by leaps and bounds. It is a long-term investment. We stuck with it. A lot of companies did not because their investment would have been greater than ours.

By repealing that, you are removing economic sanctions. I don't know how you can keep it on if you read the amendment. The law was enacted for emigration. They are letting so many people out we don't know how to handle them in this country and I understand the Israelis have a problem, too.

Mr. DOWNEY. The problem is how to handle the slots. The Israelis cannot handle it. The reason for Jackson-Vanik no longer exists. People are finding excuses to keep it alive.

Would you discuss repeal versus waiver, Mr. Murphy.

Mr. MURPHY. Speaking from my own perspective, as a U.S. company, to build these relationships, to do joint ventures, they take 3, 5 or 6 years to get going before you get the plants built, get them in operation and get something viable. To sit here and hope for a 1½-year extension and maybe then to get another 3 years, we would not make investments.

On the other hand, if I could hope for any one thing that would equalize our position with the Europeans, I wish they would enact their own version of a Jackson-Vanik bill that would be even more effective, but I don't think it will happen.

Mr. DOWNEY. At this point, I would like to include in the record a letter sent to me by Ed Bronfman, president of the World Jewish Congress, who basically makes the same points Mr. Murphy and Mr. Kendall have just made about repeal versus waiver.

[The letter of Mr. Bronfman follows:]

EDGAR M. BRONFMAN
WORLD JEWISH CONGRESS
375 PARK AVENUE
NEW YORK, NY 10152

OFFICE OF THE PRESIDENT

January 18, 1990

Dear Representative Downey:

I would like to expand on our discussion this week concerning the Jackson/Vanik Amendment to the Trade Act of 1974 and the President's decision to move toward a trade agreement with the Soviet Union. The President's decision is a significant political act that goes well beyond trade and economics. In announcing this decision, the President said that he also wants to see perestroika succeed and that he wants to do everything possible to help the Soviet Union in its efforts to join the world economy.

In light of these circumstances, I believe the Jackson/Vanik Amendment should be repealed. Its continuation is not appropriate to the present political context.

First, the conditions that led to the passage of Jackson/Vanik no longer exist. The Soviet Union does not now restrict the emigration of Soviet Jews. Furthermore, the other Communist countries at which the Jackson/Vanik provisions were aimed have also moved away from restrictive emigration practices.

Secondly, the Jackson/Vanik Amendment would impose continuing uncertainty on our new economic relations with the Soviet Union. If the original reason for the Amendment is gone, I see no reason to continue to impose such uncertainty. American business cannot plan efficiently nor can the Soviets. Given our economic importance, the Soviets cannot have a normal economic relationship with the whole world unless they have a normal one with us.

There are two methods within the Jackson/Vanik provisions to set its restrictions aside, but both impose uncertainty. A waiver requires that the issue be revisited every year. A Presidential statement that Jackson/Vanik provisions no longer apply to a particular country must be revisited every six months. Thus, the only way to remove the now inappropriate uncertainty inherent in the Jackson/Vanik provision is to repeal it.

I recognize that the Soviets could revert to earlier practices. The President, however, has sufficient authority outside of Jackson/Vanik to respond appropriately, and we both know that the Congress would not remain comatose in such circumstances. We recognize that refuseniks remain and that codification of emigration and other human rights is on the agenda. We hope, of course, the remaining refuseniks are released and codification occurs soon. It is important, however, to proceed with the negotiation of a new trade agreement aggressively.

While not specified as part of Jackson/Vanik, it is important to note that official discrimination against Jews has ended, Jewish cultural centers have opened, Hebrew and religious subjects are taught freely, and Jews have begun to organize with the first meeting of the Soviet Jewish Congress held last December.

The President spoke movingly after Malta about a new threshold that the United States, the Soviet Union and indeed the whole world can now cross. I believe this nation should endeavor to cross that threshold as unencumbered as possible by the archaic remnants of the old era. We should begin our new economic relationship by recognizing that the Soviets have answered the complaints that led to the passage of the Jackson/Vanik Amendment. To do otherwise is contemptuous of the significant steps the Soviets have taken and thus not worthy of the United States. The Jackson/Vanik Amendment has clearly served its purpose. It is time to repeal it. It is time to move on.

Sincerely,

The Honorable Thomas J. Downey
United States House of Representatives
2232 Rayburn House Office Buidling
Washington, D.C. 20515-3202

Mr. **Downey**. I would like to address to both you gentlemen, if you would just share with us your sense of where the future areas for expansion might exist with the Soviet Union possibly in health care, housing, environmental areas, where we should be looking and what potential action we in the United States might take to encourage this sort of trade.

Mr. **Kendall**. I will answer on the consumer sector. Mr. Murphy is much more familiar with the industrial sector.

In the consumer sector, you name it and they need it. As you know, recently they had to go to England to get soap. They did not have enough soap. So it is really basic things that you think of in this country as normal; they don't have it.

Back in the 1970's, I told President Nixon the best thing that could happen to improve relations between the United States and the Soviet Union was to bring all the wives of the members of the politburo and put them into the kitchen of a United States housewife and they would see all these things and go back and raise hell. The things you think of as normal, they don't have.

Mr. **Murphy**. It will be the consumer goods area rather than industrial. They will lead to the need for industrial goods to produce some of those consumer goods.

Chairman **Rostenkowski**. Mrs. Kennelly.

Mrs. **Kennelly**. Mr. Kendall, I agree it was a pocketbook revolution but I think it was more than that in that we can never forget that we really nurtured the system of democracy. We provided the role model.

Having said that, I am not one of those Marshall plan people. I know we have to get down to the business of the day. I salute you for showing us the way.

Mr. Murphy, I see from your testimony that you are suggesting that we immediately give Bulgaria, Czechoslovakia, and Romania, most-favored-nation status and get on with the business of the day.

Mr. **Murphy**. Yes.

Mrs. **Kennelly**. And that we shouldn't try to do reform at the same time?

Mr. **Murphy**. Correct.

Mrs. **Kennelly**. I have legislation which would extend MFN to those countries. I could not agree more.

While we have you here and I know you have done a lot of study on this, can you give us some insight on Romania. They had a remarkable surge in trade when they did have most-favored-nation status and at the same time they were probably one of the most repressive of all the countries, and certainly were not doing what we called for under Jackson-Vanik. What were they doing right? They fascinate me.

Mr. **Murphy**. I am not an expert on Romania, but I think what they were doing was a very effective job of asset allocation, allocating them to businesses which you see a lot of here in the United States and they did a very fine job. They ignored all the other things which are of great concern but in terms of asset allocation, they did a marvelous job for a period of time.

Mrs. **Kennelly**. Is that something we should encourage the other countries getting most-favored-nation status to do?

Mr. **Murphy**. They don't have to. They will do it.

Mrs. **Kennelly**. You are saying give them most-favored-nation status and they will do what they have to do.

Mr. **Murphy**. The most-favored-nation status is largely cosmetics. We will not be flooded with their goods because they don't have the goods but it has a major significant psychological impact on our relationships there.

Mrs. **Kennelly**. Thank you, Mr. Murphy. I agree with you completely.

Chairman **Rostenkowski**. Mr. Andrews.

Mr. **Andrews**. I gather from your testimony that your chief criticism of our policies has been a lack of consistency in the 1980's more than any other thing. You refer to the light switch approach in diplomacy as being inconsistent and, therefore, not working.

For instance, back in the 1980's, didn't we own all the oil and gas equipment as a tool of foreign policy as opposed to some economic reasons. What were the consequences of that, Mr. Murphy?

Mr. **Murphy**. Mr. Congressman, you probably recall back in the 1970's as the trade program of the United States and Soviet Union did begin to pick up steam we were exporting a substantial amount of energy-related equipment to the Soviet Union.

As I recall the numbers we were getting then, 25 to 30 percent of their total imports of those types of goods. We did things like the pipeline sanctions, the embargo on all oil- and gas-related equipment to the point now where all their imports, to the tally of $25 billion a year, were probably getting less than 1 percent.

It is coming from Western Europe, Japan, it had nothing to do with Cocom. It was our own Government decision to stop it and we did and they bought from somebody else.

Mr. **Andrews**. If you could, enumerate for us, one, two, three, what you think the most immediate and important things that we could do as a Congress.

Mr. **Kendall**. Are you talking about overall trade?

Mr. **Andrews**. Yes, with the Soviets in particular.

Mr. **Kendall**. With the Soviets or overall with everybody?

Mr. **Andrews**. The Soviets in particular.

Mr. **Kendall**. With the Soviets, I think the most important thing from their standpoint, of course, is repeal of Jackson-Vanik. Then there are companies that, obviously, don't need it, but there are industries like Mr. Murphy's where you have to repeal the Stevenson amendment and get Eximbank credits.

There are some companies, we don't need it, but other companies need OPIC where they get investment guarantees to encourage them to go after it.

I would do the same thing in the Soviet Union and Eastern Europe that we do for other countries. I don't think you need foreign aid or Marshall plans. All you have to do is give business the same opportunity that they have if they are going up to Canada, down to South America or to Europe. They are competing against somebody else who is giving credits.

The British and Japanese are giving credits and there are companies who need that. As Jack Murphy said, let's try to get a level playing field.

Mr. **Murphy**. Let me answer similar to Don, but a little different.

First, things we can do all by ourselves, we don't need anybody's agreement or any negotiations to do but, second, things which do require agreements. I will not say which is one, two or three. They are roughly the same.

First, things we can do by ourselves, largely cosmetic things, however, which have a major effect on our perceived relationship with Eastern Europe, that is repeal Jackson-Vanik.

Second, negotiate the necessary treaties, trade treaties, tax treaties, goad us up to speed with Europeans and let us do our thing.

The third area, perhaps more difficult, export controls here in the United States and Cocom that have to be negotiated, get that down to a meaningful, workable procedure so we can get answers quickly and everybody knows the ground rules.

On the financing side, decide whether or not we are going to compete with Europeans in financing Eastern Europe. That is largely a government issue. So it would be those three categories.

Mr. ANDREWS. Thank you.

Chairman ROSTENKOWSKI. Thank you, gentlemen, for joining us this morning. It has been most informative and we thank you for your participation.

Welcome to the committee.

Mr. Milosh, will you begin your testimony by first identifying yourself—and I suggest each witness as they speak identify themselves for the record.

STATEMENT OF EUGENE J. MILOSH, PRESIDENT, AMERICAN ASSOCIATION OF EXPORTERS & IMPORTERS

Mr. MILOSH. Thank you, Mr. Chairman.

I am Eugene Milosh, president of the Association of Exporters & Importers.

Mr. Chairman, stunning events have taken place in Eastern Europe toward democratization, a shift to market principles, privatization and acceptance of a multiparty system. Clearly, the process of convulsion against the past has taken on a momentum of its own and is irreversible in the near term. However, during a transition to a market economy, there is a danger that dislocations will occur leading to economic hardship and social unrest which if allowed to persist could undermine the entire region. In particular, Eastern and Central Europe have had a history of fragmentation during periods of strife and economic upheaval whereby national, ethnic, cultural, religious and territorial rivalries have emerged.

It is in the interest of the United States and western nations to collectively insure a successful transition in Eastern Europe by offering a variety of assistance measures. Ultimately, Eastern Europe will have to develop trade and the ability to export in order to service loans and pay for purchases of much needed equipment and raw materials.

For this potential to become a reality, policy agendas must be implemented in three basic areas: finance, export controls and U.S.-import liberalization. The three policy areas are not exclusive to the expansion of trade. Many other programs can help on the periphery such as student exchanges, management training, bus seminars, joint research projects, and cultural exchanges. These are certainly of value and can be classified under the category of "getting to know you," but in the hard world of business reality, will not bolster import and export trade by themselves.

Senator Dole has made a serious and thoughtful suggestion for the United States to redirect current loan allocations from other countries to Eastern Europe that would yield some $300 million without increasing the budget deficit. This is a modest amount compared to targets of $10 to $15 billion earmarked by the European Community for Eastern Europe.

Individual European countries and Japan are also preparing separate aid packages. As Senator Pell has pointed out,

> We should look carefully at reducing our military aid programs that are premised on a communist threat orchestrated from Moscow. Economic aid to Eastern Europe should be seen as a highly cost-effective form of defense spending.

For this reason, a portion of the peace dividend should be utilized in Eastern Europe, still leaving enough for domestic priorities of reinvesting in our own infrastructure, education, combating crime and drugs and lowering the budget deficit.

Much progress has been made in the area of export controls. AAEI's Export Controls Committee believes the Export Administration Act must be significantly reformed this year; a simple extension or fine tuning of the present system will not be enough to enable American manufacturers to compete in the new European markets—both East and West—or begin to counter the worldwide deamericanization trend started in part due to unpredictable and unnecessary export controls.

Currently, discussions are being held with our Cocom allies regarding the liberalization of controls on exports to East Europe. These proposals would differentiate between countries based on their commitment to safeguard the technology against diversion.

Hungary and Poland have already submitted such proposals, including agreements allowing onsite visits by Western representatives, with Czechoslovakia and East Germany expected to follow suit.

The U.S. Government's proposal includes raising the level of exportable computers to those currently allowable to the PRC. AAEI welcomes this direction, as it ties decontrol to a measurable standard, allowing for strategic planning by U.S. business interests, and offering solid evidence that Eastern Europe is cooperating and serious about reform.

Most-favored-nation status in international trade does not represent a preferred duty rate so much as it does a normalization of trade practices on a multilateral basis. It can easily be argued that MFN status should be granted to all remaining countries in Eastern Europe—East Germany, Czechoslovakia, Bulgaria, and Romania—since they are on the verge of normalizing trade relations to a greater extent than even the U.S.S.R.

To facilitate this, bilateral trade agreements need to be negotiated as quickly as possible with these countries. Romania has recently indicated their desire to regain MFN status with promises of election and reform.

A strong U.S. generalized system of preferences is a prime asset to the United States. Motivated by enlightened self-interest, the

European Communities and Japan, as well as other industrialized nations, have their own GSP programs.

The international system of burden sharing, represented by the various generalized preferential schemes of donor nations, is a vital part of an equitable system of international trading.

GSP countries, as a group, purchase from the United States nearly 40 percent of total U.S. worldwide exports. Their GSP earnings have helped them do that, and today the healthiest segment of the U.S.-trade balance is with the GSP beneficiary countries.

In the case of Poland, which has just been granted GSP, the benefits are truly modest and represent only a $2.6-million savings in duties applied to current Polish exports to the United States. While the net effect may be to increase these exports incrementally, providing GSP benefits to Poland symbolizes a willingness to help Poland during a difficult economic transition.

Similarly, Hungary is now eligible for GSP benefits and it is also necessary to consider other countries of Eastern Europe that may qualify for GSP benefits.

In my written testimony, I have given examples of how this can be accomplished in the area of textiles and apparel. In the European Community, there are plans for steel quotas in Europe and we will be, and they, have been, increasing textile quotas, although modestly.

I would now like to address United States-Soviet trade relations.

In the early 1970's, AAEI formulated a policy opposing adoption of the Jackson-Vanik amendment on the grounds that it represented confusion between trade policy and foreign policy goals. AAEI has consistently opposed the use of withdrawal of most-favored-nation tariff treatment and other hostile trade measures as an improper approach to the solution of political problems.

We have taken this position because unilateral trade sanctions rarely work effectively and in most cases injure the U.S. economy since we are now so dependent on international trade, especially in agriculture and more sophisticated products which are the first to be targeted for retaliation resulting in the abandonment of overseas markets to competitors.

Addressing those who believe that the Jackson-Vanik withdrawal of MFN treatment was correct policy, we say that the wave of emigration now permitted by the U.S.S.R. should entitle that country to a waiver, at the very least, in the most propitious manner possible.

We would suggest 3 years as a minimum so the United States can plan for this market. We must also realize that should the Gorbachev regime be replaced by Soviet reactionaries, any codification in favor of immigration rights would likely to be ignored.

The United States should develop and implement a policy toward possible Soviet accession to the GATT. The President took the initiative toward this goal in Malta. There are many proposals being discussed by various trade and business groups with many novel approaches ranging from a dual membership status for nonmarket economies to establishing criteria such as tariff reductions, import penetration and acceptance of fundamental rules of trade being discussed in the Uruguay round which is due for completion in 1990.

These include safeguard codes, intellectual property rights, inclusion of service industries and concepts of transparency in regulations and statistics. Obviously, when the GATT was founded very little thought was given to nonmarket economies, although mention in article VI recognized special problems would exist in determining pricing relative to antidumping and countervailing duties from monopoly state trading nations.

There, nevertheless, remains a great deal of skepticism in allowing the Soviets to join GATT due the their rigid system, sheer size threatening a politicization of the GATT and hesitation to complete market reform.

Considering these factors, a limited observer status would be encouraging to the Soviets while allowing time to decide future action regarding full membership. Whatever approach is adopted, it should be recognized that the GATT has always had, as a principle objective, the improvement of the world economic order, and at the same time the goal of maintaining peace among nations, all nations.

In summary, the Soviet economy has seriously faltered during the past 5 years causing economic and social problems of immense proportions that will be difficult to resolve.

The outcome will depend largely on the ability of Mr. Gorbachev and the Communist Party to reform the political and economic system that has brought on this state of affairs over a period of 70 years.

The U.S. policy should be aimed at helping to maintain and to minimize their difficulties by fostering perestroika and by normalizing our trade relations. However, if restructuring has as its primary aim, the maintaining of a one-party Communist monopoly, meaningful economic reform and prosperity will be an unfulfilled goal.

The latest upheavals in the Southern Caucus illustrates this dilemma. Because Soviet political reform has been mired in Communist Party survival strategy, it has led to social unrest in the Caspean Sea region. This has resulted in oil production slowdowns further eroding the Soviet economy.

Oil deliveries to Eastern Europe have also been curtailed coming at a critical stage in economic reform in these countries, with adverse impacts on world energy prices threatening inflation at home. In this scenario, political risk becomes a major obstacle for Western firms like Chevron, contemplating a major energy recovery project on the Caspean. No doubt, they must be experiencing anxieties. Without business cooperation, the Communist Party will take more heat for inaction and inefficiency thereby undermining their position.

I believe the normalization of our trade relationship with the Soviet Union at this juncture is a step in the right direction for maintaining world order. We should not hesitate to help bring the Soviet Union into the world market community. However, in order for this relationship to be effective, they must address their political and economic situation realistically.

[The statement of Mr. Milosh follows:]

Statement by Eugene Milosh, President of the American Association of Exporters and Importers before the U.S. House of Representatives, Ways and Means Committee, January 30, 1990

I am Eugene Milosh President of the American Association of Exporters and Importers (AAEI). Previously, during the rise and demise of Detente, 1973 through 1980, I was Vice President of Operations for the U.S.-U.S.S.R. Trade and Economic Council and was directly involved in international market development in Eastern Europe and the Soviet Union with Union Carbide Corporation for twelve years.

I am appearing before you today in my capacity as an Officer of AAEI to briefly describe the Association's position regarding extension of MFN status to the Soviet Union and Eastern Europe and also to offer my perspectives of the U.S.-Soviet trading relationship.

At the outset I would like to address U.S.-Eastern Europe trade relations separately from U.S.-Soviet trade relations in light of the basic difference that exists between the Soviet Union and that of Eastern Europe.

I. EASTERN EUROPE

Stunning events have taken place in Eastern Europe towards democratization, a shift to market principles, privatization and acceptance of a multiparty system. Clearly, the process of convulsion against the past has taken on a momentum of its own and is irreversible in the near term. However, during a transition to a market economy, there is a danger that dislocations will occur leading to economic hardship and social unrest which if allowed to persist could undermine the entire region. In particular Eastern and Central Europe have had a history of fragmentation during periods of strife and economic upheaval whereby national, ethnic, cultural, religious and territorial rivalries have emerged.

It is in the interest of the United States and Western nations to collectively insure a successful transition in Eastern Europe by offering a variety of assistance measures. It is important to keep in mind that assistance in the form of aid and loans can only be temporary and serve as a bridge. Ultimately, Eastern countries must revitalize their economies, regain their industriousness and become self reliant through free enterprise. In essence, they have to develop trade and the ability to export in order to service loans as well as pay for purchases of much needed equipment and raw materials. For the United States, opening of these markets represents an important export opportunity plus a chance to reduce our trade deficit. For this potential to become a reality, policy agendas must be implemented in three basic areas - finance, export controls and U.S. import liberalization. The three policy areas are not exclusive to the expansion of trade. Many other programs can help on the periphery such as student exchanges, management training, business seminars, joint research projects and cultural exchanges. These are certainly of value and can be classified under the category of "getting to know you", but in the hard world of business reality, will not bolster import and export trade by themselves.

A. Finance

Senator Dole has made a serious and thoughtful suggestion for the United States to redirect current loan allocations from other countries to Eastern Europe that would yield some $300 million without increasing the budget deficit. This is a modest amount compared to targets of $10-15 billion earmarked by the European Community for Eastern Europe. Individual European countries and Japan are also preparing separate aid packages. As Senator Pell has pointed out "we should look carefully at reducing our military aid programs that are premised on a communist threat orchestrated from Moscow. Economic aid to Eastern Europe should be seen as a highly cost effective form of defense spending". For this reason a portion of the peace dividend should be utilized in Eastern Europe still leaving enough for domestic priorities of reinvesting in our own infrastructure, education, combating crime and drugs and lowering the budget deficit. Applying the same 5% allocation utilized by Senator Dole to the peace dividend envisioned by the Secretary of Defense would yield another $9 billion available for Eastern Europe during the next four years.

Whatever combination of emergency loans, IMF or World Bank loans, food relief, economic aid or peace dividend allocation is formulated, we should not make our past mistakes in extending government and private credit. Loans and aid should be tied to realistic commercial projects with defined goals for growth and export potential as well as their willingness to be flexible in adapting to Western methods of commercial business practices.

B. Export Controls

Due in part to the 1988 Trade Act and the Soviet withdrawal from Afghanistan, the U.S. export control system has begun improving. The lifting of the 'no-exceptions' policy at Cocom as well as the creation of new general licenses have all served to further the exporting interests of the hi-tech business community.

However, these positive changes have not gone far enough to alleviate the unnecessary burdens still faced by hi-tech exporters. Recognition of the importance of economic security and legitimate business interests, especially in light of the trade deficit, changing global competition and our declining technological lead, must not be allowed to falter now. Since the underlying rationale for national security controls is slowly disintegrating, and the Export Administration Act is due to expire this year, it is essential for Congress to completely overhaul the existing bureaucratic maze of export regulation. AAEI's Export Controls Committee believes the Export Administration Act must be significantly reformed this year; a simple extension or fine tuning of the present system will not be enough to enable American manufacturers to compete in the new European markets (both East and West), or begin to counter the worldwide "de-americanization" trend started in part due to unpredictable and unnecessary export controls.

Currently, discussions are being held with our Cocom allies regarding the liberalization of controls on exports to East Europe. These proposals would differentiate between countries based on their commitment to safeguard the technology against diversion. Hungary and Poland have already submitted such proposals, including agreements allowing on-site visits by Western representatives, with Czechoslovakia and East Germany expected to follow suit. The U.S. government's proposal includes raising the level of exportable computers to those currently allowable to the PRC. AAEI welcomes this direction, as it ties decontrol to a measurable standard, allowing for strategic planning by U.S. business interests, and offering solid evidence that Eastern Europe is cooperating and serious about reform.

C. Import Liberalization

1) Most Favored Nation Status in international trade does not represent a preferred duty rate so much as it does a normalization of trade practices on a multilateral basis. It can easily be argued that MFN status should be granted to all remaining countries in Eastern Europe - East Germany, Czechoslovakia, Bulgaria and Romania since they are on the verge of normalizing trade relations to a greater extent than even the U.S.S.R. To facilitate this, bilateral trade agreements need to be negotiated as quickly as possible with these countries. Romania has recently indicated their desire to regain MFN status with promises of election and reform.

2) A strong U.S. Generalized System of Preferences is a prime asset to the United States. Motivated by enlightened self-interest, the European Communities and Japan, as well as other industrialized nations, have their own GSP programs. The international system of burden sharing, represented by the various generalized preferential schemes of donor nations, is a vital part of an equitable system of international trading. GSP countries, as a group, purchase from the U.S. nearly 40% of total U.S. world-wide exports. Their GSP earnings have helped them do that -- and today the healthiest segment of the U.S. trade balance is with the GSP beneficiary countries. In the case of Poland, which has just been granted GSP, the benefits are truly modest and represent only a $2.6 million savings in duties

applied to current Polish exports to the United States. While the net effect may be to increase these exports incrementally, providing GSP benefits to Poland symbolizes a willingness to help Poland during a difficult economic transition. Similarly, Hungary is now eligible for GSP benefits and it is also necessary to consider other countries of Eastern Europe that may qualify for GSP benefits.

3) Quotas - One of the most effective methods of improving a country's economy is developing industries that have a real and immediate export potential. While many industries require time to tool up and modernize, more often quick export results can be realized by increasing or redistributing quotas on products such as textiles and apparel, steel, food and other import sensitive goods. The President has the authority to increase quotas under Section 204 of the Agricultural Act of 1956, but because of the political nature of quotas, would require non-legislative support from Congress and trade unions. I might add that unions in the United States have a stake in Poland as well, by insuring that the Solidarity backed government is a success. As an example of textile and apparel quota redistribution, I have included in my testimony (as attached A) a summary of year-end 1989 quota filled rates by category. If you will notice categories 433-Men's Jackets and Group IV-Men's and Women's Suits reached their quota limits while other categories with large quotas were not fully utilized, such as 447-Men's Trousers and 639-T-shirts and Pullovers. Obviously, import quotas could be increased substantially in items that have a demand without exceeding aggregate quota limits for total Polish exports of textiles and apparel. This quota switch methodology can spur increased exports during a period of transition in all of Eastern Europe. This type of administrative adjustment does not require legislation, just cooperation.

II. SOVIET UNION

A. Most Favored Nations Status

In the early seventies AAEI formulated a policy opposing adoption of the Jackson-Vanik Amendment on the grounds that it represented confusion between trade policy and foreign policy goals. AAEI has consistently opposed the use of withdrawal of Most Favored Nations Tariff treatment and other hostile trade measures as an improper approach to the solution of political problems.

We have taken this position because unilateral trade sanctions rarely work effectively and in most cases injure the United States economy since we are now so dependent on international trade - especially in agriculture and more sophisticated products which are the first to be targeted for retaliation resulting in the abandonment of overseas markets to competitors.

In my opinion, the Jackson-Vanik amendment was not the prime reason for the Soviet rejection of the 1974 Trade Agreement, rather, it was the Stevenson and Byrd Amendments. These amendments restricted government sponsored credits to the U.S.S.R. in an aggregate amount of 300 million dollars, and more importantly with no loans permitted for production of fossil fuel energy resources. As I recall, the Soviets rejected the trade agreement when they understood clearly, that compliance with Jackson-Vanik still meant no credits under the Stevenson Amendment. From a Soviet perspective, the trade agreement was a bad deal requiring the Soviets to repay some $750 million in lend lease in exchange for very limited credits and none for developing their energy resources.

In the case of Jackson-Vanik there is no clear parallel or consistent linkage between trade volumes, tariffs and emigration, which draws one to the conclusion that other factors contribute to Soviet emigration policies, such as their internal economic situation, standard of living, unemployment and changes in leadership.

Addressing those who believe that the Jackson-Vanik withdrawal of MFN treatment was correct policy, we say that the wave of emigration now permitted by the U.S.S.R. should entitle that country to a waiver, at the very least, in the most propitious manner possible.

We must also realize that should the Gorbachev regime be replaced by Soviet reactionaries, any codification in favor of immigration rights would likely to be ignored.

Any further humiliation of a government floundering on a sea of troubles is not in our long term interest of supporting those in the U.S.S.R. whose policies advance the cause of peace and reduction in mutual military threat and high levels of defense expenditures. As a practical matter, given the slim possibilities for a major expansion of U.S.-Soviet trade, the granting of most favored nation tariff treatment is hardly significant. Yet, this symbolic act will be a contribution to stabilization of a very dangerous situation within the Soviet sphere of influence and could place U.S. agricultural exports in a more favorable position. Other sectors representing export opportunities are in chemical processing, extractive mineral industry and energy development. Considering the projected world oil supply and demand situation, another major supplier would help stabilize world prices.

B. Soviet GATT Membership

The U.S. should develop and implement a policy towards possible Soviet accession to the GATT. The President took the initiative toward this goal in Malta. There are many proposals being discussed by various trade and business groups with many novel approaches ranging from a dual membership status for nonmarket economies to establishing criteria such as tariff reductions, import penetration and acceptance of fundamental rules of trade being discussed in the Uruguay Round which is due for completion in 1990. These include safeguard codes, intellectual property rights, inclusion of service industries and concepts of transparency in regulations and statistics. Obviously, when the GATT was founded very little thought was given to non-market economies, although mention in Article VI recognized special problems would exist in determining pricing relative to anti-dumping and countervailing duties from monopoly state trading nations. There, nevertheless, remains a great deal of skepticism in allowing the Soviets to join GATT due to their rigid system, sheer size threatening a politicization of the GATT and hesitation to complete market reform. Considering these factors, a limited observer status would be encouraging to the Soviets while allowing time to decide future action regarding full membership. Whatever approach is adopted, it should be recognized that the GATT has always had as a principle objective the improvement of the world economic order, and at the same time the goal of maintaining peace among nations - all nations.

The Soviet economy has seriously faltered during the past five years causing economic and social problems of immense proportions that will be difficult to resolve. The outcome will depend largely on the ability of Mr. Gorbachev and the communist party to reform the political and economic system that has brought on this state of affairs over a period of seventy years. The United States policy should be aimed at helping to minimize their difficulties by fostering perestroika and by normalizing our trade relations. However, if restructuring has as its primary aim the maintaining of a one party communist monopoly, meaningful economic reform and prosperity will be an unfulfilled goal. The latest upheavals in the Southern Caucusus illustrates this dilemma. Because Soviet political reform has been mired in communist party survival strategy, it has led to social unrest in the Caspean Sea region. This has resulted in oil production slowdowns further eroding the Soviet economy. Oil deliveries to Eastern Europe have also been curtailed coming at a critical stage in economic reform in these countries, with adverse impacts on world energy prices threatening inflation at home. In this scenario, political risk becomes a major obstacle for Western firms like Chevron, contemplating a major energy recovery project on the Caspean. No doubt they must be experiencing anxieties. Without promise of business cooperation, the communist party will take more heat for inaction an inefficiency thereby undermining their position.

I believe the normalization of our trade relationship with the Soviet Union at this juncture is a step in the right direction for maintaining world order. We should not hesitate to help bring the Soviet Union into the world market community. However, in order for this relationship to be effective, they must address their political and economic situation realistically.

Chairman ROSTENKOWSKI. Thank you, sir.

Mr. Jenkins.

STATEMENT OF KEMPTON B. JENKINS, CHAIRMAN, EAST-WEST TRADE COMMITTEE, U.S. COUNCIL FOR INTERNATIONAL BUSINESS AND CORPORATE VICE PRESIDENT FOR GOVERNMENT AND INTERNATIONAL AFFAIRS, ARMCO

Mr. JENKINS. Thank you, Mr. Chairman. I am Kempton Jenkins. I represent the U.S. Council for International Business. I have a full statement which I request be included in the record.

Mr. GIBBONS [presiding]. Without objection.

Mr. JENKINS. The Soviet Union has exceeded our wildest expectations. I, like many who have worked on U.S. policy toward these countries, was confident that some day this would happen; but I never thought we would live to see it, Mr. Chairman.

As Congressman Pickle said, today we now have to ask ourselves, what do we do about this? The U.S. Council, and I think the American business community in general, agree on two basic points. The challenges of economic reform, particularly in the Soviet Union, are immense and will require unprecedented action if East-West trade is to expand significantly.

Moscow, for example, must virtually abandon the centralized Leninist control over resource allocation to the marketplace.

The nonmarket economy practices, which Mrs. Johnson spoke about, are one problem, but our policy should be designed to incentivize reforms and end those nonmarket economies.

We don't have a problem with how to handle them. We need to get rid of them, and I think if we take the right actions in this historic situation, we will see that happen.

Second, while they pale in significance and difficulty compared to the challenges for Moscow, they are important steps the U.S. Government can and should take to encourage reform and to optimize whatever business opportunities emerge.

My written statement discusses the necessary actions for both sides in some detail. Let me simply list here as Congressman Andrews suggested the actions, that the U.S. Government in my judgment should at this time address and act upon.

Obviously, a multiyear waiver of Jackson-Vanik is the first order of business. But that really is almost a given in today's situation. We know that is going to happen. We are talking about how to make it happen most effectively, but we cannot stop with that action.

We have to go on, as Jack Murphy pointed out, to the Stevenson and Byrd amendments, both of which make it impossible for the American oil patch to participate in the development of energy resources in the Soviet Union, which is the one area, the one sector in the Soviet economy, that holds out promise for significant increase in Western investment and can generate some actual profits for U.S. corporations in the near future.

Rejuvenation of the Eximbank has been discussed, also, by Jack. I feel very deeply that unless we take action to make the Eximbank a cardinal player in our East-West trade policy, all of the other steps we take will be no more than cosmetic.

It is important for us to recognize that we are in a competitive global marketplace, and we have unilaterally disarmed the Eximbank of this country under the Reagan administration to where we, in fact, are no longer able to compete on a financial basis for deals in the Soviet Union, Eastern Europe, or for that matter, in most of the world. Particularly, however, in the Eastern European Soviet arena, rejuvenation of the Eximbank is critical, and it is urgent.

Several speakers have touched also on the need to reform the Export Administration Act. It's complicated, and it's not exactly a pure trade question. But it's essential if we are going to preserve an effective Cocom to recognize that our allies are moving out. And we will, if we drag our feet, simply bring about the collapse of Cocom.

We can enable U.S. business to compete effectively for legitimate business by reforming the Export Administration Act and dealing with the issues that have to be dealt with there.

Finally, my friend, Dick Schulze, asked me to comment that in the trade agreement under section 405 that among the other things which we have to meet, there are ten targets, as you know, that have to be met in a trade agreement with a nonmarket economy.

Patent protection looms very large and is very important. I am confident that the Soviets would be responsive and the Eastern Europeans, if the administration came forth with a proposal on patent protection as part of this; but it cannot be overlooked.

The Soviet actions are the things which are really awesome. They have to bring about price reform. Three times the central committee has stepped up to this issue and backed away from it in the last 18 months.

They have to allow labor mobility and training, and they have to disarm their conventional forces because it's the tech sergeants of the Red Army who, in fact, can have an immediate jump start effect on the consumer industries of the Soviet Union.

Currency, reform and convertability can flow from all of this, and GATT participation in turn can also flow from all of those steps. But to talk about GATT, in the abstract, without these other steps taking place, is to ignore the reality of GATT.

There is no role for the Soviet Union in its present economic makeup in the GATT. My hope is that GATT membership is an incentive for them to carry out these reforms. We have got to recognize that the United States is but one player in this process. But we should not fail to accelerate the transformation which has been central to United States policy objectives since Harry Truman took the first historic steps to confront and contain Soviet imperialism.

President Bush is correct in recognizing the need for prudent and a proportional response to these opportunities, and we should celebrate the fact that our allies are stepping up to their international financial responsibilities together with us.

It warmed my heart to see Prime Minister Kaifu in Eastern Europe with a big bag of money to put on the table, and I think it's high time. We draw deep satisfaction from the knowledge that the sacrifices of American citizens on the battlefields of the cold war and the bills in taxes we paid for aid and defense programs since the end of World War II have been critical in bringing about these dynamic developments we are now witnessing.

Therefore, we believe the United States should leave no stone unturned to encourage this historic development now.

Thank you, Mr. Chairman.

[The statement of Mr. Jenkins follows, along with a supplemental statement from the U.S. Council for International Business:]

STATEMENT
on
SOVIET-AMERICAN TRADE
before the
HOUSE WAYS AND MEANS COMMITTEE
for
THE U.S. COUNCIL FOR INTERNATIONAL BUSINESS
by
Kempton B. Jenkins
January 30, 1990

Mr. Chairman, I am Kempton Jenkins, Corporate Vice President for Government and International Affairs at Armco and Chairman of the East-West Trade Committee of the U.S. Council for International Business. The U.S. Council for International Business represents American business positions in the major international economic institutions and before the Executive and legislative branches of the U. S. Government. Its primary objective is to promote an open system of world trade, finance, and investment. The U.S. Council is the U.S. business group that officially consults with key international bodies influencing international business, such as the International Chamber of the Commerce (ICC), the Business and Industry Advisory Council to the OECD (BIAC), and the International Labor Organization (ILO). The U.S. Council will be submitting written testimony on E.C. 1992 and Foreign Direct Investment to complement my remarks today.

I am honored to have this opportunity today to address economic issues very much in the news at present: the future of Soviet-American trade. We applaud the Committee for devoting its attention to the critical policy decisions in this area.

Clearly, reevaluation of our long-established trade policies towards the Soviet Union and Eastern Europe is overdue. Events in the Soviet Union and Eastern Europe have captured the attention of the world in recent months as moribund and morally bankrupt political regimes have given way to new and still evolving structures. However, in a sense, these sudden dramatic political changes appear easy in comparison to the necessary economic restructuring that must now follow.

Economic reform will take much time and be difficult to accomplish, and require new and creative approaches to policymaking. Furthermore, the various nations in the region differentiate themselves more and more every day, highlighting the need for individual solutions to individual problems. Certainly countries like Poland and Hungary have leapt ahead of "Perestroika" in the Soviet Union, and Czechoslovak and East German economic reform will take different approaches than those adopted in Poland or Hungary. The prospects for enhanced trade opportunities with the countries of Eastern Europe are considerably brighter than those involving the Soviet Union. This results not only from the fact that they have, to one degree or another, faced up to the basic economic reforms which are essential, but also their much longer Western industrial experience and tradition.

No U.S. corporation can long afford an investment or joint venture in a marketplace where returns are not comparable to what they would be in other markets. There is no way in the world that the Soviet Union, given the basic price structure, convertibility, labor relations and generally antiquated relationship between the consumer and the producer can compete, e.g., with Mexico or the Philippines (which while in some chaos, nonetheless have a long tradition of doing business with the Western world). There are also many other countries who are far, far ahead of the Soviet Union in their market conditions and offer much more promising prospects for U.S. investors.

PROBLEMS WITH THE SOVIET MARKET

Subsequently, I will describe some concrete and positive steps which the United States can take to improve Soviet-American trade. However, before I get to that, I want to emphasize the very serious Soviet structural problems which will continue to impede growth in U.S.-Soviet trade, which must be addressed by the Soviets. These constitute historic developmental problems and basic political challenges and they dwarf in significance the steps which the U.S. can take.

First, the Soviet population of 280 million potential consumers constitutes a market without the wherewithal to buy. The majority of people and enterprises have no hard currency with which to purchase U.S. (or any other Western exports) and are not likely to acquire such hard currency for the foreseeable future. Without basic economic reform which in turn could lead to a convertible ruble, a large increase in imports, regardless of the needs or desires of the population, will remain out of reach.

Second, prospects for moving to a convertible ruble seem little brighter today than they did five years ago. The necessary economic reforms promised by "Perestroika" have proved elusive and politically untenable to date. Gorbachev has backed off of the most important element in a viable reform package: abandoning state control of resource allocation or decontrol of the centrally-planned price system. As recently as November, 1989, the political leadership considered and rejected a meaningful launch of price reform, in the face of fierce political opposition, settling instead for half-hearted measures, a new 5-year plan, which is more of the same and promises of changes to come. Without price reform and implementation of basic supply and demand relationships, the Soviet economic crisis is unlikely to abate. As a result, too many rubles will continue to chase too few goods, the ruble "overhang" (defined as unspent and unproductive ruble hoarding among the population) is likely to continue, and convertibility of the ruble will remain a fantasy.

Third, the Soviet leadership faces a major constraint to revitalizing their economy in the lack of labor mobility and of a skilled labor force for the consumer sector. With rigid central planning, workers have had little choice as to where best to market their skills and as a result, labor resources have been inefficiently allocated in the economy, driving up production costs unnecessarily. Most of the most skilled workers and managers have been concentrated in the military sector and without large-scale downsizing of the Soviet military force, productive and competitive use of that labor pool is unlikely.

Furthermore, it is important to recognize that the Soviet Union remains a nation composed of different ethnic groups with little in common in terms of culture, religion, and language. Recent events in Azerbaijan have demonstrated the bitter rivalries that exist among the non-Russian ethnic groups. Translated into labor terms, this means that shifting significant numbers of Uzbek laborers to the Ukraine is not likely to work smoothly or productively. In addition, significant portions of the overall population are drawn from rural areas with little desire or readiness to transfer pastoral skills into a factory environment. Thus, there is both a shortage of mobile labor at present as well as a shortage of "factory-ready", qualified, laborers who can produce goods competitively.

Fourth, as far as encouraging a healthy import-export trading component to the national economy is concerned, the Soviets continue to suffer from a lack of not only goods available for export but more importantly, goods competitive on the world market. Currently, the Soviet exports are comprised largely of raw materials (much like a Third World country). The quality of finished goods which the Soviets produce is not up to world standards, especially in a global economy dominated by low-cost, high-quality manufacturers. Without a long, painful (AND SUCCESSFUL) Perestroika, the Soviets will continue to fall behind.

All of these fundamental flaws will discourage U.S. investors.

U.S. TRADE POLICIES NEED REFORM

Now, having painted a somewhat gloomy portrait of Soviet near-term economic prospects, I would still emphasize that U.S. trade policies towards the Soviet Union need reform. I would characterize the necessary changes in our trade policies as simply "normalizing" U.S.-Soviet trade. While they pale in significance compared to the many structural changes in the Soviet economy, they can be significant in encouraging those within the Soviet Union who are pressing for political and economic reform.

Certainly, the Bush Administration's support for granting the Soviet Union "Observer" status in the GATT following completion of the Uruguay Round marks an important step in normalizing overall trade relations. The U.S. Council supports this Administration move, although we hope that our policymakers will continue to insist on significant economic reforms in that country as the price of admission to the world trading system. The U.S. Council has recommended that the Administration, in consultation with our Western allies and OECD trading partners, devise economic reform "benchmarks" to monitor Soviet progress towards a market-driven economy. Such a system would provide support to those working for economic reform within the Soviet Union while also protecting the GATT from the negative effects of integrating a huge, centrally-planned economy into the world trading system.

The United States and the Soviet Union reportedly have agreed to negotiate this spring a new trade agreement which will provide appropriate opportunities and safeguards for the development of American trade and business relations with the Soviet Union. In addition to meeting the tests established in the Trade Act of 1974, these unique problems need to be addressed:

MFN -- The clearest example of needed reform lies in the area of Most Favored Nation tariff status or MFN. As you well know, the Soviets were denied MFN beginning in 1973 on the basis of their restrictive emigration policies, under the Jackson-Vanik Amendment. The U.S. Council strongly supports repeal or at least a waiver of the Jackson-Vanik Amendment at this time. However, our support for MFN does not derive from economic considerations. In 1988, the volume of trade between the two countries did not even total $3 billion and the prospects for large-scale expansion of Soviet-American trade are not good. Lack of a convertible ruble and the resulting shortage of hard currency, inefficient allocation of labor resources, and uncompetitive goods for an export sector all diminish the attractiveness of the Soviet market for Western investors and traders. Until the Soviets abandon the Stalinist command economy and allow the market to dictate the allocation of capital and labor resources, the economic effect of MFN on trade between the two countries will remain minimal.

However, the Soviets have largely met the conditions of Jackson-Vanik, codifying new and liberal emigration policies. Thus, little justification remains for denying the Soviets MFN on this basis. Granting MFN at least will help normalize Soviet-American economic relations and demonstrate support for those working for reform within the Soviet Union.

The Stevenson Amendment -- The Stevenson Amendment, along with Jackson-Vanik, restricts the Export-Import Bank to a total of $300 million exposure in the Soviet Union. In addition, individual projects are subject to review by Congress. The Amendment, which dates back to 1974, has had a chilling effect on business projects in that country and has effectively stymied any expansion of U.S. commercial credit for Soviet projects. We support repeal of the Amendment at this time.

The Export-Import Bank -- The entire question of the Ex-Im Bank as an instrument of U.S. foreign policy needs reevaluation . First established in the 1930's specifically to provide economic assurance to American companies doing business in the Soviet Union, in recent years the bank's fortunes have languished. When viewed in comparison with Export-Import banks in West Germany and Japan, our endowment of Export-Import financing pales. In addition to encouraging Ex-Im Bank activity in the Soviet Union, the Bank surely merits rejuvenation of its overall efforts. It is the logical instrument to encourage American business activity in the Soviet Union (as well as Eastern Europe), and has a vital role to play in strengthening our competitive capabilities in other parts of the world.

The Byrd Amendment-- The Byrd Amendment in the Trade Act of 1974 specifically prohibits any official U.S. financial exposure for fossil fuel projects in the Soviet Union. The Amendment is a particularly critical barrier to developing trade with the Soviet Union since energy resources are one of the few hard-currency producing exports which the Soviet Union has to offer. If the Soviets are to accelerate their economic integration into the industrial world, freeing all possible resources to develop their energy output from Siberia holds a high priority. Given a belief that Soviet integration into the world economy is a desirable goal, the U.S. Council supports repeal of this amendment.

OPIC -- The Overseas Private Investment Corporation has been prohibited both by its own legislation and by Jackson-Vanik from providing political insurance to American companies interested in investing in Eastern Europe and the Soviet Union. Political risk guarantees offer American business the assurance that their government stands behind their efforts in these new markets, which is particularly important in countries like the Soviet Union where U.S. business does not currently operate under an investment protection treaty. Therefore, there are no provisions for international arbitration or against nationalization or expropriation of foreign investments. While the risk of such events occurring in the Soviet Union may seem unlikely at present, without government backing, American investors have little incentive to run risks exploring whatever trade possibilities exist. Significantly, other countries such as West Germany and Belgium have concluded investment protection treaties with the Soviet Union in the past year. While the U.S. Council supports the Administration's efforts to negotiate such a treaty in time for the summit, we believe that OPIC also has a meaningful role to play in complementing the initiative. Just as OPIC has received authorization recently to underwrite projects in Poland and Hungary, it should also be authorized to support projects in the Soviet Union.

The Export Administration Act -- A great deal of attention is currently being focussed on the overall issue of export controls and their efficacy in accomplishing their intended purpose. Clearly, a reexamination of their implementation is overdue and, indeed, there has been movement in recent weeks by the Administration to extend special consideration to exports destined for Eastern European countries under the proviso that the technology exported remain in those countries and not be retransmitted to third countries, such as the Soviet Union.

However, the issue is more complex than implied by such initiatives. For too long, our export control policy was unduly influenced by those who sought to stifle virtually all exports, both "high" and "low"-tech products, to the Soviet Union on the grounds of national security. Clearly, the issue does involve national security and the business community is dedicated to supporting enforcement of export controls of sensitive items. However, while we are firm proponents of a maximum degree of efficiency in our COCOM efforts to prevent the escape of militarily significant technology to our principle adversaries, we also believe a targeted refined system is more urgent today than ever before. Our policy should rely on reducing the list of controlled items to those that are really important, while increasing enforcement and punitive penalties for those few who deliberately circumvent Western controls and sell military technology to our adversaries.

There are a few important points to keep in mind in this debate. First, the days when the United States could unilaterally control exports of high technology in the world are over. We face serious and unrelenting competition from some of our closest allies in producing high tech products and our ability to stop particular countries from obtaining certain products is minimal. In fact, close study of the worldwide availability of currently controlled items reveals a lack of effectiveness of our current export control policies. When other non-COCOM countries readily step in to provide products on the controlled list, the only result is that American businesses lose sales and the American economy loses jobs.

Second, the incredible pace of change in Eastern Europe and the Soviet Union in recent months has brought welcome news politically, while at the same time causing considerable uncertainty about the future direction and purpose of the Western alliance. In the 1990's we must work together with our COCOM allies to fashion an export control policy that both satisfies our partners as to the rationale behind control of particular items as well as allows each COCOM member, and particularly the United States, to feel confident that national security concerns are being addressed satisfactorily. Consultation and agreement will work to our advantage, while weakening alliance unity sends a signal to Moscow of weakness, not strength.

A New Tax Treaty

Finally, the United States should enter into negotiations with the Soviet Union for a new tax treaty. Richard M. Hammer of Price Waterhouse, who is Chairman of our tax committee, will speak to you tomorrow on the importance of modernizing the current U.S./U.S.S.R. treaty. He will also recommend that the United States expand its tax treaty network to include those countries in Eastern Europe with whom we do not now have treaties.

CONCLUSION

Our world has seen more changes in the past few months than at virtually any other time in recent history. Precepts of containment and immutable opposition Blocs have given way to hope for a different and better way of co-existence and a reduction in the threat of nuclear war. A 45-year national objective is coming within reach, thanks to the dedication and wisdom of our Presidents, from Truman to Bush, and the sacrifices of the American people. These new conditions require new thinking.

As I have outlined, the Soviets face serious and long-standing problems in trying to jump-start their economy. The failure of Marxist-Leninist economics has been made abundantly clear in the last few years as even Perestroika and "reformist socialism" appear to be running out of gas. Until the Soviets face up to the need for thoroughgoing reform, starting with basic price reform, they are likely to continue to harvest the results of an untenable economic program.

While the steps that the U.S. can take to facilitate Soviet-American trade may not result in a large expansion of the trading relationship, we strongly believe that normal trade relations are worth pursuing. The stakes are high, not necessarily in terms of immediate economic pay-offs, but rather in a framework of global economic and political stability.

U.S. policymakers should be seeking ways by which to accelerate the integration of the Soviet Union into the world economy. A Soviet Union, engaged in the world economy and whose stake in that economy is as large as other major states, is much more likely to be dominated by rational managers who would have strong incentives to behave in a stable, responsible manner in both the political and economic realms than a disengaged, isolated, and economically threatened Soviet Union run by ideologues.

Finally, my remarks today have focused on the Soviet Union, but there is a similar urgency to modify our economic relations with the other countries in Eastern Europe, which in many ways are in significantly different situations than the Soviet Union. It is important to continue to eliminate restraints that prevent U.S. business from participating on the same footing as foreign businesses in the economic revitalization of these countries. This will require modifications tailored to meet varied individual circumstances of these countries, as was done with Poland and Hungary in the Support of Eastern European Democracy Act.

The Administration and Congress have a unique opportunity to help accomplish that result through a shift in U.S. trade policies. I am confident that U.S. business stands ready to work with you in whatever way desirable.

Thank you.

SUPPLEMENTAL STATEMENT

WRITTEN STATEMENT OF THE

THE UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

SUBMITTED TO THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

ON
FOREIGN INVESTMENT IN THE UNITED STATES
AND THE EUROPEAN SINGLE MARKET
AND
TAX POLICY IMPLICATIONS

FEBRUARY 20, 1990

Dedicated to promoting an open system of world trade, finance, and investment, the United States Council for International Business represents American business positions in the major international economic policy making institutions and to the Executive and Legislative branches of the U.S. Government.

The U.S. Council is the U.S. business group that officially consults with the key intergovernmental bodies influencing international business. As the U.S. member of the International Chamber of Commerce (ICC), the Business and Advisory Committee to the OECD (BIAC), and the International Organization of Employers (IOE), the U.S. Council represents American business views to the United Nations bodies, the World Bank and GATT, to the Organization for Economic Cooperation and Development (OECD, and to the International Labor Organization (ILO).

In addition, the Council expresses U.S. business views on issues before the European Community, including as a member and the secretariat of the U.S. Industry Coordinating Group (USICG).

FOREIGN DIRECT INVESTMENT IN THE UNITED STATES

The interests of the U.S. economy and of American business are best served by working towards a free and open international investment environment, and this goal necessitates the preservation of such a system in the U.S. Restricting or discriminating against foreign direct investment in the U.S. could seriously damage the interests of American companies by encouraging the maintenance and proliferation of barriers to their competitiveness and trade expansion strategies.

The U.S. Government is presently in the forefront of multilateral negotiations aimed at further opening the international investment environment--negotiations which will be crucial elements in ensuring continued growth in U.S. trade and investment overseas into the twenty-first century. These include negotiations on strengthening the OECD Governments' commitment to the principle of national treatment of foreign investors (as contained in the 1976 OECD Declaration on International Investment and Multinational Enterprises), and the Uruguay Round negotiations on trade-related investment measures (TRIMs), aimed at applying GATT principles and disciplines to government investment policies.

At the same time, however, the impression continues to exist outside the United

States that the U.S. has made a drastic turn towards a protectionist stance with respect to foreign investment in this country.

The U.S. Council has a particular interest here, in its capacity as the representative of U.S. business in the international organizations where these issues are discussed.

In comments to the U.S. Treasury Department on the draft regulations to implement the "Exon-Florio" provision (Section 721) of the Defense Production Act, the U.S. Council made clear that it recognizes that these regulations are intended only to protect the national security of the United States without raising unnecessary obstacles to foreign investment, and to do so in a manner fully consistent with the international obligations of the United States.

In an Administration policy statement delivered to a meeting of the U.S. Council on February 9 by Assistant Treasury Secretary Charles Dallara, and in statements following the decision not to allow the continued investment of the China National Aero-Technology Import and Export Company in Mamco, the Administration has indicated that it will continue an open policy towards foreign investment in this country. The U.S. Council supports this approach.

Any regulations that fail to protect the legitimate interests of foreign investors in the United States would likely lead to retaliation against U.S. investors in foreign countries, and would undermine current U.S. efforts to achieve more liberal investment policies worldwide. Moreover, there is ample evidence that foreign direct investment is playing an important role in helping reduce our stubborn trade deficit, by providing the capital, skills, and jobs that enhance U.S. competitiveness. Onerous regulations that restrict foreign direct investment create a negative climate for investors and may threaten the health of the U.S. economy.

Similar trends are taking place in particular in the tax area. For example, during the debate of the recently adopted Revenue Reconciliation Act of 1989, tax proposals were considered which disregard generally accepted international tax principles and the United States' international treaty obligations. In letters to Congress, the U.S. Council opposed these measures on the grounds that they would discourage foreign direct investment and are discriminatory in that they treat foreign-owned U.S. companies differently from U.S. companies owned by U.S. stockholders. Moreover, some of the provisions contravene the terms of treaties which have been negotiated by the U.S. Government, and ratified by the Senate. Continued unilateral actions by the U.S. Government to override treaties will most certainly be viewed negatively by foreign governments, who may implement retaliatory action. At a time when international relations, particularly in the trade area, seem to be significantly improving, it seems wrong to make changes in the tax system that will impair trade relations between the U.S. and other nations.

Among the proposals contained in the Act are those which could deny U.S. deductions for interest paid to related foreign lenders and force foreign companies to subject their non-U.S. activities legal process. Proposals remain on the table to override U.S. income tax treaties and end recognized exemption of capital gains on direct investments, contrary to OECD treaty procedures and practice.

The U.S. Council is concerned that rules such as these may be an overly aggressive assertion of U.S. taxation rights that may lead to conflict with foreign governments, resulting in retaliatory regulatory actions against U.S.-based companies. We believe that it is of mutual interest to tax administrations and taxpayers that there be a harmonization of substantive rules and administrative policies. We urge that future tax legislation be drawn in a manner that will not be viewed as a trade barrier or provoke retaliatory action by other governments.

THE EUROPEAN SINGLE MARKET

The E.C.'s program to complete its internal market by December 31, 1992, will be of enormous consequence to Europe, the world economy as a whole and to the U.S. economy and American companies. The United States Council supports this initiative and believes that it will result in a more open and dynamic market which will benefit U.S. companies ready to take advantage of the opportunities it will offer.

The E.C.'s single market program is the acceleration of a process that began in 1957, with the signing of the Treaty of Rome which established the European Economic Community. Then as now, the goal is to create a common market free of restrictions on the movement of goods, services, people, and capital. Both the U.S. Government and American business have consistently supported this goal, stressing the importance of creating a dynamic European economy, and recently, of emerging from the economic stagnation that pervaded Europe in the 1970s and early 1980s.

As long as these goals are achieved through deregulation and growth, it is up to U.S. business to take advantage of the market opportunities afforded. However, U.S. companies would be opposed to "harmonization" at the E.C. level which resulted in more burdensome regulation or bureaucracy, and to measures that resulted in discrimination against firms of non-E.C. origin investing in or exporting to the Community.

Following the recent events in Eastern Europe, the Community's single market initiative has become subsumed in a larger context, in which the E.C. is propelled into addressing questions of the "architecture" of Europe--of whether and how to form a "broader" and "deeper" union. First, there is the question of creating a larger economic space, through membership by, or trade and association agreements with, the countries of the European Free Trade Association (EFTA) and Eastern Europe. At the same time, these events have stimulated an intensified debate about the pace of progress towards union among the E.C. countries. There is increasing pressure for the creation of economic and monetary union and other common policies "beyond" the single market program (e.g., social policy and foreign policy), coupled with institutional reform aimed at increasing the powers and the representativeness of the E.C. institutions--the Commission and the European Parliament. American companies doing business in Europe will be affected both by new arrangements formed between the E.C. and other European countries, and by further commitments among the E.C. countries to common policies and common decision making structures.

The U.S. Stake

U.S. business is interested in the Single Market initiative because of the impact it will have both on the European marketplace in which it operates and on the environment for trade and investment worldwide.

"1992" is one of a number of major developments, along with the Uruguay Round, and the U.S.-Canada Free Trade Agreement, that make this a time of unprecedented opportunity for creating an open world trade and investment system. It is also a time of great risk, if any of these developments fail in their market liberalization objectives, and if protectionist tendencies should prevail.

American business and the U.S. economy have an enormous stake in the Community. The E.C. is the largest recipient of U.S. exports and investment. The E.C. accounts for almost 25% of U.S. exports ($75.9 billion in 1988). This is slightly greater than exports to Canada, and far greater than to Japan, other East Asian countries or Latin America.

In addition, a full 40% of U.S. foreign investment is in the E.C. (about $126 billion in 1988). In 1986, U.S. affiliates in the E.C. employed 2.5 million people and their sales were estimated at $430 billion. In some sectors, they represent a substantial portion of the market. Moreover, these investments play an important role in U.S. exports. It is estimated that in 1986, $18 billion of $53 billion total exports to the E.C. were accounted for by exports to U.S. subsidiaries.

Opportunities

Many U.S. companies are taking the E.C. single market initiative into account in developing new business strategies, and the opportunities being opened by the 1992 program may indeed cause American (and other) firms to invest in, or trade with, Europe when they might not have done so otherwise. To the extent that these decisions are a result of market forces, and a response to greater opportunities afforded by a larger, faster growing market, and by increased economies of scale, this development should be welcomed as a potential boon to U.S. business and the U.S. and world economy.

Growth in the E.C. resulting from integration will mean greater market opportunities for American companies. The "Cecchini Report," commissioned by the E.C., anticipates that approximately 5% will be added to E.C. GDP in the medium term, as a result of reduced barriers, with a net increase of about 1.8 million jobs. While some consider these forecasts optimistic, E.C. GNP already rose 3.7% in 1988, following steady 2% growth over previous years, and more new jobs are being created than at any time since the 1960s.

Elimination of border controls would reduce costs associated with delays in transporting goods from one country to another. Already, for example, the E.C. has adopted a Single Administrative Document that replaces some 70 different forms required at border crossings. It is estimated that this will reduce transportation costs for companies within Europe by 7%, as well as reduce required inventory stocks. Transportation costs should also be reduced as the road, sea, and air transport service markets are liberalized.

Harmonization or mutual recognition of national regulations and standards for goods and services would mean that a product would have to comply with only one set of requirements, rather than twelve, to be marketed freely throughout the E.C. This should in many cases allow U.S. companies to more efficiently serve their European customer base.

As a result, a number of companies have plans to consolidate European operations (production or sales). However, in some sectors, such as financial services or certain consumer products, it will continue to make more sense to market on a regional or local basis. An integrated market simply allows strategies to be based more directly on market need rather than political boundaries.

In addition, U.S. firms earning licensing fees and royalties in Europe, or which have trademarks to protect, will benefit from new intellectual property regulations that extend high standards uniformly across the E.C.

Challenge--Competitiveness

The principle challenge for U.S. business will be a more competitive business environment in Europe. The impact of integration on U.S. business will vary among industries and individual companies, depending on how well they are positioned to face increasingly competitive European firms. Many U.S. companies, with experience trading and operating in the U.S. market and throughout Europe, are well equipped to meet this challenge and to take advantage of the opportunities discussed above. Many U.S. companies invested in Europe early and have often done business on a Europe wide basis to a greater extent than their European counterparts.

However, it is the intention of the 1992 program to increase the competitiveness of European firms through greater use of the market. Already, European companies are posing new challenges to American firms in a number of areas, not only in Europe, but in the U.S. and third markets, as well. The opening of new potential markets in Eastern Europe creates additional opportunities and challenges for U.S. business in Europe--the opportunity to use experience in the E.C. market to do business in Eastern Europe, and the challenge of competition with European businesses to take advantage of these opportunities.

Concerns

Nonetheless, while we believe that the overall direction of the program is towards market liberalization, the substance of the program, and the potential problems, lie in the details of the numerous specific pieces of legislation proposed by the Community. In some cases, measures contain provisions that would pose problems for European and non-European firms alike. In other cases, provisions may potentially result in discrimination against non-E.C.-based firms. In all cases, the concerns center on the unnecessary distortion of markets that would make it difficult for companies to take advantage of the larger market that is being created in Europe.

The U.S. Council has expressed specific concerns on a wide range of individual E.C. initiatives, and these are summarized in its Statement on the European Single Market, which is available from the U.S. Council. The areas addressed by the U.S. Council include: air and maritime transportation; competition policy; economic and financial policy; environment; industrial relations; insurance; intellectual property; telecommunications and information policy; marketing, advertising and distribution; public procurement; services; standards; and trade policy.

There is concern, for example, that European standards and regulations on specific goods and services, as well as testing methods and certification procedures, could be established which do not take account of broader international standards or which create new obstacles to imports. Business would also be concerned if European-wide standard setting or testing and certification requirements resulted in new, unnecessarily burdensome regulation or bureaucracy.

For example, on certification and testing requirements, the Council expressed the concern that the different categories of requirements were drawn too broadly, so that products that pose little or no potential hazard to the consumer, or which currently can be "self-certified" by the producer, would have to comply with the more rigorous compliance requirements.

Further, incomplete or divergent national implementation of E.C. directives could result in the maintenance or creation rather than the dismantling of trade barriers within the Community. For example, the E.C.'s Product Liability Directive, while adopted by the Council of Ministers, has not been implemented in a consistent way throughout the E.C., therefore maintaining a divided market.

There are concerns about E.C. rule of origin decisions aimed at preventing circumvention of anti-dumping duties, which might have the effect of inducing companies to increase E.C. sourcing of production even when this is not the most cost-efficient solution.

Another example of where EC legislation might result in a barrier to imported goods is in the area of product safety. The Commission has proposed that manufacturers based in the E.C. be required to monitor the safety of their products from cradle to grave. For goods originating outside the E.C., this obligation rests with the importer. Distributors who would usually choose to import certain products, might instead seek suppliers inside the Community, thereby avoiding having to set up a monitoring program. The monitoring requirement, instituted for safety reasons, could therefore put imported goods at a general disadvantage.

There have also been concerns about the use of the concept of reciprocity in E.C. legislation. It is not clear if the E.C. will interpret this as requiring national treatment or "mirror legislation" of third countries, in order for their firms to have access to the E.C. market. Although the relevant clause of the Second Banking Directive was amended, its implementation should be monitored as access to the E.C.'s market, and possibly even national treatment of previously established enterprises, are is still conditional on the treatment of E.C. firms in non-E.C. markets, and similar "mirror image" clauses are still contained in other proposals, on life insurance and investment securities. A reciprocity provision has also most recently been included in the E.C.'s Regulation on cross-border mergers in the E.C.

For companies with establishments in the E.C., the Treaty of Rome--Article 58--guarantees that firms established in an E.C. member state shall be treated as member state nationals under Community law. For U.S. companies, it is important that no qualification is made to this general principle in the context of specific 1992 measures. This concern was raised recently over the proposed directive on road haulage, which had included citizen equity conditions for a company to qualify for a license to operate throughout the E.C. While this provision was removed from the directive as it was recently agreed, we believe that this is a trade-restrictive proposal that could crop up again in future revisions or in other E.C. directives.

Also, European firms under new competitive pressures could be favored over those based outside the Community through quantitative restrictions, maintenance of subsidies, discriminatory public procurement practices, and restricted access to E.C. research and development programs.
Pressures for protection will be exerted by certain European business quarters, though on the whole, they seem to take an open, liberal approach. Also, fear of Japanese competition may lead to measures affecting U.S. interests. The E.C. Commission has identified three major sectors in which problems are expected: automobiles, electronics, and textiles. They have also identified two smaller ones: sewing machines and motorbikes. It remains to be seen in what additional sectors problems will be encountered.

Conclusions--U.S. Response

The U.S. Government should continue to support the E.C.'s efforts to integrate its market. We have welcomed recent statements by the current Administration to this effect in meetings with E.C. officials in recent months.

We believe that the main issue raised for business by the 1992 program is that of competitiveness, and that the Government's focus should be on how to enhance the ability of U.S. companies to compete in world markets, in light of developments, such as economic integration in the E.C., and the opening of the East European economies, which are changing the whole competitive environment for business world-wide.

For example, in the tax area, we urge the U.S. Government to seek better harmonization of tax policies with the E.C. so that U.S. companies will be able to take advantage of E.C. plans to streamline and harmonize the tax structures of its Member States. This can only be accomplished if the U.S. Government moves quickly to remove barriers in U.S. laws to allow U.S. companies to compete on a level playing field in Europe. Subpart F rules should be amended to treat the E.C. as one country for the purposes of computing foreign company sales or services income. In addition, we urge the U.S. Government to examine its tax policies with a view towards encouraging increased European investment in the U.S.

At the same time, the Government should ensure through negotiations at both the bilateral and the multilateral levels that discriminatory measures are not introduced in the process of integration, and that the E.C.'s market remains open to investment and trade from outside the Community.

We continue to believe that a key element of ensuring that this process results in an open E.C. for U.S. business is to strengthen broader international commitments to liberalization, particularly in the context of the Uruguay Round of GATT negotiations, scheduled for completion at the end of 1990. A successful result from the Uruguay Round (achieving reduced tariffs and non-tariff barriers, and including agreements on services, intellectual property, and investment, as well as on rules of origin and local content, and the improvement and extension of the GATT Agreement on Government Procurement) would go a long way in addressing business community concerns about E.C. measures in these areas.

Still, the bilateral track must also be pursued in areas, such as services and rules of origin, where it is needed to prevent potential damage to business while the Government is pursuing multilateral negotiations.

Last, it should be recognized that any measures taken by the U.S. Government which could be construed as protectionist, for example, proposals which stress strict sectoral reciprocity or compromise the principle of unconditional national treatment, could provoke protectionist reactions at this critical moment in liberalizing the system both in Europe and globally. This makes achievement of liberalization on a multilateral basis all the more important.

Mr. **Gibbons**. Thank you, Mr. Jenkins.

Mr. Robinson and then Mr. McNeill.

STATEMENT OF ROGER W. ROBINSON, JR., PRESIDENT, RWR, INC., WASHINGTON, DC

Mr. **Robinson**. Thank you, Mr. Chairman.

I am Roger Robinson, president of RWR, Inc., a Washington-based consulting firm and was former Senior Director for International Economic Affairs at the National Security Council.

Prior to my Government service, I was a vice president in the U.S.S.R. Eastern Europe Division of Chase Manhatten Bank for a 5-year period.

With the chairman's permission, I would like to submit my full testimony for the record.

Chairman **Rostenkowski**. Certainly, without objection.

Mr. **Robinson**. The administration and the Congress are now faced with a number of major decisions concerning the future conduct of United States-Soviet/East European economic relations. In my prepared testimony, I examine the backdrop against which these decisions are likely to be made by assessing Soviet creditworthiness.

Roughly a dozen commercial and political risk factors are provided that should be taken into account. In sum, although Soviet creditworthiness is in the process of significant deterioration, the Soviet Union continues to enjoy substantial access to foreign credit markets.

Nevertheless, should Soviet indebtedness continue to rise at the present rate and hard currency earnings remain depressed, the need for either formal or informal debt rescheduling arrangements could materialize when the gross debt level reaches $60 to $70 billion.

The highly uncertain domestic political environment, particularly the prospect of debilitating strikes by the work force, could accelerate the downside risk for Western private and official creditors significantly.

Turning to the issues for congressional consideration, I would like to offer bottom line positions on three of the five issue areas that I have outlined in my testimony.

Concerning the granting of most favored nation status for the Soviet Union, it is important that President Bush's initial terms for the granting of equal tariff treatment to the U.S.S.R. be observed, namely codification and implementation of emigration as a right of the Soviet people, not a privilege.

Without a track record of at least several months after codification, there is a substantial risk that subtle bureaucratic slippage could de facto deny emigration to Soviet citizens as an inalienable right. Assuming that a credible track record on codified free emigration is established by Moscow, I would support granting MFN status to the Soviet Union on a temporary basis.

The other issue covered by the Jackson-Vanik and Stevenson amendments, however, pertains to the restoration of Soviet access to U.S. Export-Import Bank (Eximbank) credits and loan guarantees. In my judgment, this is far more problematic than granting MFN.

Since 1974, U.S. taxpayers have been free of either direct or contingent liabilities related to the financing of U.S. industrial projects and trade with the Soviet Union. Private creditors and investors have appropriately assumed the risk of any future debt rescheduling or default by Moscow of the type that took place in Poland in March 1981.

Before this advantageous situation for average Americans is changed by the administration and the Congress, there should be a clear understanding of the implications and risks of such a policy shift.

Accordingly, the Congress should focus on five basic issues outlined in my prepared testimony when considering renewed Soviet access to Eximbank programs.

An issue to which I would like to draw this committee's attention involves the negotiations currently underway between the State Department and the Soviet Union to settle defaulted czarist and other debt obligations—for example, lend-lease—to the United States reported to exceed $1.5 billion. Such a settlement, perhaps for a few cents on the dollar, would release Moscow from the restrictive provisions of the Johnson Debt Default Act of 1934, thereby permitting Soviet borrowing in the U.S. securities market.

Although this bilateral debt-settlement exercise appears harmless, it has major strategic implications for the 1990's and beyond. One of the principal components of Moscow's financial agenda toward the West is to develop an expansive presence in the international securities markets—for example, through issuing bonds, notes, commercial paper, and so forth. Achieving this goal would broaden the sources of Soviet borrowing in the West from only Western governments and banks to include securities firms, pension funds, insurance companies, corporations, and even individuals.

Over time, hundreds and perhaps thousands of Western nonbanking institutions—like securities firms and pension funds—and millions of Western citizens could be either knowingly or unknowingly holding Soviet paper in their bond portfolios and pension funds.

Turning to Eastern Europe, the still incomplete revolution of 1989 has produced some optimistic prospects for making the difficult transition from command to market economies, from one-party rule to democracy. At this time, the countries showing the best prognosis for successful Western investment and systemic transformation are Czechoslovakia and Hungary. Those countries with a less certain future include the GDR, Poland, Bulgaria, and Romania.

For example, on the political front, the Communist Parties of Romania and the GDR are currently attempting to reassert control against the will of the people which risks renewed social turmoil and possible violence in 1990.

Czechoslovakia has emerged as the pacesetter for regional economic and political reform movements, with its commitment to: a market economy; the quick removal of all Soviet forces; ceasing cooperation with Moscow in the areas of foreign espionage and technology theft—thereby lowering Western security costs—banning the export of Semtex plastic explosives used by terrorists; and, challenging COMECON's debilitating nonmarket trading arrangements.

Prague's willingness to help reduce Western security costs by discontinuing damaging intelligence-related cooperation with Moscow should be adopted immediately by other East European recipients of Western economic, financial, and technological assistance.

In sum, I support the prudent expansion of United States economic and financial relations with U.S.S.R. and particularly with Eastern Europe, so long as such relations are properly managed. The overarching task of the administration, the Congress, and indeed the Western Alliance, is to determine how best to advance the movements toward true democracy and free markets in these countries.

For example, large-scale infusions of Western capital and technology into the U.S.S.R. have served to retard, not catalyze, genuine systemic reform. Accordingly, a more cautious and disciplined approach to the channeling of Western assistance resources to certain countries of the region is essential to maintaining the kind of constructive pressure which is working in favor of those seeking the fundamental, structural transformation of these societies.

In short, greater Western discipline, transparency, and selectivity will ultimately do more to help Mr. Gorbachev initiate a far more radical and productive perestroika II than simply rewarding continued economic mismanagement.

Mr. Chairman, as the taxpayer implications of technology transfers and related export controls to the East bloc are an indispensable part of overall East-West economic relations, I request permission to submit for the record a brief paper prepared by a colleague at the Center for Security Policy which could contribute to these hearings.

[The statement of Mr. Robinson and an attachment follow:]

STATEMENT OF ROGER W. ROBINSON, JR.
PRESIDENT, RWR, INC.

Mr. Chairman, I am pleased to have the opportunity to appear before the House Committee on Ways and Means to examine U.S. trade relations with the Soviet Union and Eastern Europe. I have had the good fortune to participate in the management of East-West economic and financial relations from both public and private sector positions. As Senior Director for International Economic Affairs at the National Security Council and Executive Secretary of the Cabinet-level Senior Interdepartmental Group on International Economic Policy for three and a half years (1982-1985), I participated in many of the Reagan Administration's major international economic policy decisions, including those pertaining to East-West trade. Prior to coming to government, I was a Vice President in the USSR/Eastern Europe Division of the Chase Manhattan Bank.

The Administration and the Congress are now faced with a number of major decisions concerning the future conduct of US-Soviet/East European economic relations. The policies of our allies will be profoundly affected and hopefully shaped by U.S. decisions made over the next six months. Among the issues requiring congressional action are:

(1) the likely waiver of the Jackson-Vanik amendment and eventually the Stevenson amendment to the Trade Act of 1974;

(2) the terms of settlement with the USSR on defaulted czarist and other debt obligations to the United States (permitting Soviet borrowing in the U.S. bond market);

(3) policy decisions required in the context of a comprehensive bilateral Trade Agreement with the Soviet Union now being drafted for signature during the June summit of President Bush and Chairman Gorbachev.

(4) the review of U.S. positions formulated by the Administration for the Conference on East-West economic relations scheduled to take place in Bonn in late March under the auspices of the Conference on Security and Cooperation in Europe (CSCE); and

(5) decisions related to consolidating the movement toward democracy and market economies in Eastern Europe.

Before examining certain of these policy considerations, it is useful to review briefly the backdrop against which these decisions are likely to be made.

Deteriorating Soviet Creditworthiness

From earlier days as an East-West banker, I have found that an assessment of Soviet creditworthiness can be instructive in highlighting commercial and political risks for both U.S. business interests and taxpayers. Accordingly, some of the "bottom lines" of such an assessment are outlined:

- Perestroika, at least as currently configured, is dead in the water with little prospect for revival. This view is shared by observers as diverse as leading Soviet economists and NATO.

- The new Soviet Five Year economic plan is symptomatic of the causes of perestroika's decline as it represents a continuation of bankrupt central planning and further postpones genuine systemic reform such as decontrolling prices, privatizing industry, and permitting forms of private ownership.

- Other major contributors to the demise of what may be termed "perestroika I" were the estimated 3 percent real increases in Soviet defense spending in each of the first four years of Gorbachev's government and the precipitous drop in tax revenues caused by his anti-alcohol campaign.

- The fledgling Soviet private sector -- exemplified by the cooperatives -- is being increasingly vilified in the media and Congress of Peoples' Deputies as engaged in "price gouging and profiteering." Inordinately high taxes, price controls, and other newly imposed restrictions are undermining entrepreneurial incentives for this otherwise productive sector.

- Soviet oil production, the most strategic sector of the civilian economy, is declining which bodes ill for meeting the rigid requirements of the domestic economy, Eastern Europe, and the crucial hard currency export market. Production dropped in 1989 from 12.6 million barrels per day at the beginning of the year to 12.1 million barrels by year-end. It will be very difficult for the domestic economy alone to absorb even a six percent supply shortfall.

- Moscow's total annual hard currency income remains only about $37 billion or roughly one-third of the yearly sales of General Motors Corporation. Between 80-90% of Soviet annual hard currency earnings stem from just four export items -- oil, gas, arms, and gold -- commodities which face substantial price and market volatility.

- Virtually all of Moscow's hard currency income is used just to purchase imports from the West and to service debt. This means that the majority of the hard currency requirements to meet Soviet global commitments (client-state support, financing of arms sales, espionage, technology theft, disinformation, etc.) have had to be financed through Western borrowing and possibly the sale of portions of Soviet strategic gold reserves.

- According to a recent defector from Moscow's economic hierarchy, Soviet leadership has been spending a portion of its strategic gold reserves annually since 1986 in the expectation of a turnaround in perestroika's fortunes which has yet to materialize. If true, this could mean that rather than possessing strategic gold reserves traditionally estimated to be in the range of $25-32 billion, remaining Soviet reserves could be as low as $17-24 billion (assuming about $2 billion in annual depletions).

- The Soviet hard currency loan portfolio to Third World countries, often viewed as an important "asset" by Western creditors, is estimated to be somewhere in the range of $40-$50 billion. As the majority of these loans were in support of arms sales to impoverished client-states like Nicaragua, Vietnam, Ethiopia, and Syria, the real value of this portfolio may be only in the range of 10-30 cents on the dollar or less depending on the country.

- Moscow has been borrowing rather heavily since the fourth quarter of 1988. In 1989, the Soviet Union engaged in gross borrowing in the West totaling about $9 billion and continues to borrow at a similar pace this year. Total Soviet gross indebtedness is now about $50 billion, more than double the amount in 1984. The USSR's debt service ratio has similarly doubled in this period to about 28 percent.

- The promises made by Soviet leadership to striking coal miners last summer have not been kept. This has caused serious resentment in the labor force which could easily result in new strikes by miners and possibly transport workers. Any large-scale labor unrest in these crucial sectors could create a dire economic emergency.

- Finally, the political landscape within the USSR is highly volatile, fueled by increasing labor unrest, ethnic strife, consumer shortages, huge pent-up inflation, and division at leadership levels. The political tensions currently afflicting Azerbaijan, Georgia, Moldavia, the Baltics, and other republics need not be explained here.

In sum, Soviet creditworthiness is in the process of significant deterioration as evidenced by gradually rising interest rates on Western credits to the USSR. This is not to imply that the Soviet Union no longer enjoys substantial access to foreign credit markets. Indeed, given the current dearth of creditworthy sovereign borrowers elsewhere in the world, due to the ravages of the international debt crisis, Western bankers and securities firms contunue to offer Moscow more borrowing opportunities than the USSR needs. Nevertheless, should Soviet indebtedness continue to rise at the present rate and hard currency earnings remain depressed, the need for either formal or informal debt rescheduling arrangements could materialize when the gross debt level reaches $60-$70 billion. The highly uncertain domestic political environment, particularly the prospect of debilitating strikes by the work force, could accelerate the downside risk for Western private and official creditors significantly.

Issues for Congressional Consideration

Granting of Most-Favored Nation Status.

This traditional symbol of U.S.-Soviet trade impediments warrants reconsideration due to much improved Soviet performance on emigration. Nonetheless, it is important that President Bush's initial terms for the granting of equal tariff treatment to the USSR be observed, namely codification *and implementation* of emigration as a right of the Soviet people, not a privilege. The Congress should be particularly concerned over indications of significant erosion in the Administration's demands for this latter condition.

There is a clear need for the "words" of codification to be reinforced by the "deeds" of implementation or a track record of performance on truly free emigration *prior to* the President's waiver of the Jackson-Vanik amendment. Without a track record of at least several months, there is a substantial risk that subtle bureaucratic slippage could de facto deny emigration to Soviet citizens as an inalienable right. For example, the recent Soviet decision to devalue the exchange rate of the ruble by tenfold for tourists has the restrictive effect of drastically reducing the amount of hard currency that Soviet citizens can obtain when departing the Soviet Union, effectively limiting them to roughly $30. Assuming a credible track record on codified free emigration is established by Moscow, I would support a temporary waiver of Jackson-Vanik pertaining to MFN status.

Restored Soviet Access to Eximbank Credits and Guarantees

The other issue covered by the Jackson-Vanik and Stevenson amendments pertains to the restoration of Soviet access to U.S. Export-Import Bank (Eximbank) credits and loan guarantees. In my judgment, this is far more problematic than granting MFN. Since 1974, U.S. taxpayers have been free of either direct or contingent liabilities related to the financing of U.S. industrial projects and trade with the Soviet Union. Private creditors and investors have appropriately assumed the risk of any future debt rescheduling or default by Moscow of the type that took place in Poland in March 1981. Repeated Polish debt reschedulings have, in effect, led to U.S. taxpayer losses totaling about $2.3 billion. (Although Polish debt obligations to Eximbank and the Commodity Credit Corporation (CCC) are still carried as "assets" on U.S. books with the hope of eventual recovery, virtually every commercial bank in the world has written off its Polish debt.)

Before this advantageous situation for average Americans is changed by the Administration and the Congress, there should be a clear understanding of the implications and risks of such a policy shift. First, unlike MFN which was used as an effective lever to increase emigration from the USSR, restoring Soviet access to Eximbank and CCC programs should not be based on *nonfinancial* criteria, such as emigration. Instead, the Congress should focus on five basic issues in considering the restoration of Soviet access to Eximbank programs:

(1) Eximbank credits and loan guarantees constitute U.S. taxpayer subsidies of trade with USSR -- pure and simple;

(2) The disturbing increase in Soviet commercial and political credit risk would be transferred from U.S. commercial banks onto the shoulders of U.S. taxpayers already beleaguered by the savings and loan debacle, the international debt crisis, troubled leveraged buy-outs, the HUD scandal, and other U.S. government-guaranteed credit programs that have gone sour;

(3) The signal sent to allied governments, notably Japan, and the world's commercial banks would be a "political green light" for large-scale Western government-backed lending to the Soviet Union that, in turn, would probably delay further genuine systemic reform in the Soviet Union;

(4) The need to justify to the fledgling governments of Eastern Europe, Latin American democracies, poverty-stricken African nations and others how the Soviet Union warrants new taxpayer-backed loans when Moscow can borrow at very low rates on private Western credit markets and when availability to such U.S. government loans and guarantees is so limited.

(5) The fact that a recent Wall Street Journal/NBC News poll indicated that 66 percent of the American people oppose any forms of direct economic aid to the Soviet Union.

Eximbank direct loans and credit guarantees represent subsidies because the U.S. government is either taking on all the credit risk up-front (i.e., direct loans) or on a contingency basis (i.e., guarantees) in the event of Soviet inability at some future time to meet its obligations to private U.S. lending institutions. Commercial banks that are covered by U.S. government credit guarantees would price their loans to the USSR on the basis of U.S. government risk, not on an assessment of Soviet risk. Not surprisingly, this practice artificially lowers the interest rates on loans to Moscow below normal market terms. Senator Bill Bradley in testimony before the House Banking Subcommittee on International Finance, Trade, and Monetary Policy on September 22, 1988 summed up this aspect of Eximbank credit guarantees when he stated:

> "When are these government guarantees important? First, they are just like any other subsidy. Because the financing is backed by the full faith and credit of the lender's government, the borrower gets better terms. Second, they insulate lenders from the full extent of the risk of doing business in the USSR and pass that risk onto the taxpayers. Third, the data on the extent and magnitude of insurance and guarantees is quite sketchy. Western governments are apparently reluctant to let voters and taxpayers know just what good deals the Soviets are getting."

In this connection, the Soviet Bank for Foreign Economic Affairs can, for example, borrow on Western securities markets at rates as low as 6 3/8 percent for eight-year maturities. The interest rate for the USSR on medium-term, untied syndicated loans is about 1/4-3/8 over LIBOR (London Interbank Offered Rate) for similar maturities, up from as low as 1/8 percent in 1987. At a time when many developing countries, like Poland, have lost normal access to private Western credit markets, it is important to reserve limited Eximbank availability for those countries in greatest need.

For those who suggest that Eximbank funding is essential for the competitiveness of U.S. exports to the USSR, the burden of proof is on them to explain how Eximbank, under current circumstances, could be expected to "make the difference" for U.S. firms. Eximbank has encountered the prospect of serious losses in recent years, as evidenced by the need to establish a $4.8 billion loss reserve for the bank's loans and guarantee portfolio. In fact, a "subsidies war" with our allies on export credits to the USSR is a losing proposition and would only add to an already heavy U.S. taxpayer burden wrought by subsidies for wheat sales to the Soviets. Finally, it is useful to keep in mind that U.S. exports and jobs stemming from our trade relations with Latin American democracies and elsewhere dwarf those associated with trade with the USSR.

Permitting Soviet Borrowing in the U.S. Securities Market

The State Department has already held at least two sessions with the Soviet Union designed to settle defaulted czarist and other debt obligations (eg., Lend-Lease) to the United States reported to exceed $1.5 billion. Such a settlement, perhaps for a few cents on the dollar, would release Moscow from the restrictive provisions of the Johnson Debt Default Act of 1934. This U.S. legislation was intended to disallow untied U.S. bank lending (eg., the underwriting of Soviet bonds) to countries in default on any debt obligations to the United States. Over the past two decades, however, U.S. banks have circumvented this legislative restriction on untied, general purpose loans to the Soviet Union by simply lending out of offshore subsidiaries and branches.

Although this bilateral debt-settlement exercise appears harmless, it has major strategic implications for the 1990s and beyond. One of the principal components of Moscow's financial agenda toward the West is to develop an expansive presence in the international securities markets (eg., through issuing bonds, notes, commercial paper, etc.). Achieving this goal would broaden the sources of Soviet borrowing in the West from only Western governments and banks to include securities firms, pension funds, insurance companies, corporations, and even individuals. Over time, hundreds and perhaps thousands of Western *nonbanking* institutions (like securities firms and pension funds), and millions of Western citizens could be either knowingly or unknowingly holding Soviet paper in their bond portfolios and pension funds.

Moscow is very mindful of the enormous political advantage of recruiting powerful new constituencies throughout Western societies which would have a *financial vested interest* in supporting continued economic and even political concessions to the USSR. Such support could easily take the form of lobbying efforts to expand Western government loans, guarantees, and energy-related assistance to Moscow should the Soviet Union have its access to private credit markets curtailed by its deepening economic and political crises.

Other factors which argue strongly for NATO and Japanese government discouragement of Western bank and nonbank underwriting of Soviet bond and note offerings are as follows:

(1) This form of Soviet borrowing is, by definition, untied to any specific trade transactions or projects, hence loan proceeds can be used by Moscow to finance any purposes *it deems appropriate*, including activities inimical to Western security interests. (Undisciplined, general purpose Western lending to the USSR is already costing U.S. taxpayers billions of dollars annually in the form of additional defense spending required to counter the harmful consequences of funding Soviet global operations[1].)

(2) The extension of credits by nonbanking institutions to the Soviet Union are not recorded in any Western statistics as adding to the total indebtedness of the USSR and thus constitute hidden Soviet borrowing.

(3) Soviet entry into the securities markets represents a fundamental penetration of Western societies for the first time without a commensurate ability to determine those institutions and individuals holding Soviet paper and what amounts are involved.

At this writing, the Soviets have successfully concluded seven or eight bond offerings in the West since market entry in January 1988, valued at between $1.3-1.6 billion, (4-5 West German-led deals, 1 Dutch, 1 Austrian and 1 Italian.) U.S. banks and securities firms are already involved in this new line of commercially unsound sovereign lending.

Bilateral Trade Agreement

It is as yet unclear which specific items will be covered by the new U.S.-USSR bilateral Trade Agreement. The Administration may be considering a "scaled down" agreement that provides the Soviets with MFN, restored access to Eximbank credits (possibly deferring waiver of the Stevenson amendment), a favorable settlement on defaulted debt obligations to the United States, energy cooperation initiatives and other benefits. There may not be sufficient time to include provisions which protect intellectual property rights and offer investment protection for U.S. companies. The Administration may argue that they can address these issues in a follow-on Bilateral Investment Treaty. This approach, however, runs the risk of providing the Soviets most of what they have requested, while postponing the U.S. agenda of benefits.

One of the most important negotiating objectives which should be pursued by the Administration is the break-up of the Soviet trade monopoly overseen by the Military Industrial Commission (VPK), the KGB, the Ministry for Foreign Economic Relations, and the Soviet Chamber of Commerce and Industry, in that order.

These entities screen virtually all Western investments in the USSR, intervening when necessary to carry out defense requirements of the central plan. According to a 1987 State Department White Paper,[2] they are responsible for an enormous amount of Western trade diverted to the military and intellectual property theft. As long as this import monopoly exists, Soviet enterprise managers will have limited freedom to engage in normal international trade and conduct independent transactions with U.S. firms; U.S. partners in joint ventures will find that Soviet promises of "national treatment" ring hollow; and Soviet defense industries will reap a trade bonanza from technologies made available by the relaxation of COCOM controls. The Congress will probably wish to ensure that this and other trade and investment liberalization measures are achieved in the Trade Agreement.

CSCE Economic Conference

In the final days of the Reagan Administration, Secretary of State George Shultz caved in on long-standing U.S. opposition to FRG Foreign Minister Hans-Dietrich Genscher's insistence on an East-West economic conference under CSCE auspices that would address major issues such as technology transfer, finance and energy relations. The FRG expectation appears to be that the Soviet Union in particular would benefit greatly by the development of an "alliance consensus" on these and other priority issues that would accommodate Moscow's economic and financial gameplan toward the West.

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[1] For more information on this point and related subjects, it is strongly recommended that the video tape and/or transcript be obtained of a one-hour special entitled "Follow the Money" produced by the Blackwell Corporation, Washington, D.C. which was aired by the Public Broadcasting System nationwide on July 12, 1989.

[2] Intelligence Collection in USSR Chamber of Commerce and Industry, U.S. Department of State, 1987.

The United States should be very cautious concerning this rather heavy-handed FRG intervention designed to stimulate a "follow the flag" march by private Western banks and companies into Soviet markets. This could easily result from allied business communities witnessing a cornucopia of government-sponsored investment protection agreements, energy cooperation initiatives, and trade and credit support programs at the Bonn conference.

Regrettably, FRG interests and those of the United States do not coincide in selecting this kind of formal "governments to governments" structure to promote East-West economic and financial relations. For example, the Administration has consistently resisted calls by our friends in Latin America and elsewhere for similar North-South and debtor-creditor conferences which will presumably have to be reevaluated in the interest of fairness and equal treatment. Foreign Minister Genscher's utter disregard for the national security dimensions of technology, financial and energy transactions with the USSR should also be cause for significant U.S., Japanese and British concern. (The Administration is currently in the process of being stampeded by Bonn and Moscow into a CSCE "heads-of-government" meeting to deal with the sweeping changes in Eastern Europe and the USSR, in a manner reminiscent of the economics conference.)

Eastern Europe

The still incomplete "revolution of 1989" has produced some optimistic prospects for making the difficult transition from command to market economies, from one-party rule to democracy. As such prospects for economic and political reform vary widely in the region, Western assistance efforts are being appropriately tailored to individual country circumstances. At this time, the countries showing the best prognosis for successful Western investment and systemic transformation are Czechoslovakia and Hungary. Those countries with a less certain future include the GDR, Poland, Bulgaria, and Romania. On the political front, the communist parties of Romania and the GDR are currently attempting to reassert control against the will of the people which risks renewed social turmoil and possible violence in 1990. (MFN for Romania and other U.S. trade and financial assistance measures for these two countries should be withheld pending the outcome of free and fair elections.)

Czechoslovakia has emerged as the pacesetter for regional economic and political reform movements, with its commitment to: a market economy; the quick removal of all Soviet forces; ceasing cooperation with Moscow in the areas of foreign espionage and technology theft (thereby lowering Western security costs); banning the export of Semtex plastic explosives used by terrorists; and, challenging COMECON's debilitating nonmarket trading arrangements. Hungary is in close competition with Czechoslovakia in several of these areas. Poland has shown great courage in its "cold turkey" shift to more market conditions, but the country's massive debt overhang and other infrastructure bottlenecks are likely to hobble any near-term turnaround. *Prague's willingness to help reduce Western security costs by discontinuing damaging intelligence-related cooperation with Moscow should be adopted immediately by other East European recipients of Western economic, financial, and technological assistance.*

There are two key areas where the West can selectively expand its already impressive array of trade and financial assistance to Eastern Europe. One would be through the establishment with our allies of a Contingency Energy Fund (CEF) to offset any energy supply shortfalls from the Soviet Union resulting from either oil production problems or political arm-twisting. Such a CEF for Eastern Europe (and in the future, the Baltic republics) would be similar to initiatives such as the currency stabilization fund and emergency food supplies to Poland and would likely reduce Moscow's temptation to exercise its substantial energy-related leverage in the region.

The second area involves the structuring of the French-proposed European Reconstruction and Development Bank for Eastern Europe (ERDB). It now appears as though the USSR may be invited to have a place at the table in the management of the ERDB. This structural error would be compounded by also permitting Moscow to be a recipient of bank funds, particularly loans on concessionary terms. In this regard, the experience of the Asian Development Bank (ADB) may be instructive. During the Reagan Administration, India and China -- both countries that can easily attract private credits -- had swallowed as much as 40 percent of the ADB's total loan portfolio, thereby squeezing out more needy member countries. Given the USSR's enormous capital requirements to jump-start its stagnant economy, hard currency credits urgently required by, for example, Poland and Hungary, could be rerouted to Moscow.

Conclusion

In sum, I support the prudent expansion of U.S. economic and financial relations with USSR and particularly with Eastern Europe, so long as such relations are properly managed. The overarching task of the Administration, the Congress, and indeed the Western Alliance, is to determine how best to advance the movements toward true democracy and free markets in these countries. For example, large-scale infusions of Western capital and technology into the USSR have served to retard, not catalyze, genuine systemic reform. Accordingly, a more cautious and disciplined approach to the channeling of Western assistance resources to certain countries of the region is essential to maintaining the kind of "constructive pressure" which is working in favor of those seeking the fundamental, structural transformation of these societies. In short, greater Western discipline, transparency, and selectivity will ultimately do more to "help" Mr. Gorbachev initiate a far more radical and productive "perestroika II," than simply rewarding continued economic mismanagement.

Finally, the Soviet Union is now in the rearguard, not the vanguard, of political and economic reform in the East. The more restrained Japanese and American attitudes toward trade and financial relations, in part shaped by several instances of Soviet retreat from such systemic changes as a multiparty system and price reform, stand in sharp contrast to most of Western Europe's unbridled enthusiasm to prop up increasingly untenable economic half-steps. It is crucial that the Alliance partners in the coming months forge a more visionary consensus than exists today on directing limited Western financial resources to those countries *clearly committed* to our common economic and political goals.

THE
CENTER
FOR
SECURITY
POLICY

Submitted Testimony by Frank J. Gaffney, Jr.
Director of the Center for Security Policy
on

THE APPLICATION OF NATIONAL SECURITY EXPORT CONTROLS TO THE EAST BLOC

before the U.S. House of Representatives
Foreign Affairs Committee Subcommittee on
International Economic Policy and Trade
25 January 1990

Why Do Export Controls Still Matter?

As this Committee knows, historically the United States has relied upon the maintenance of a decided technological edge over the Soviet Union to deter the latter's quantitatively superior military forces. I see no reason to believe that events now taking place in the Soviet bloc, incipient arms control agreements or any other factor currently in prospect will alter this longstanding reality.

Western export controls effected under the voluntary arrangement known as COCOM have been highly effective in safeguarding this qualitative edge. Indeed, *I believe that a powerful impetus for the present Soviet effort to improve its relationship with the West has been to undo this control regime and to enable the USSR to secure with relative ease access to* advanced Western dual-use technology.

Should the Soviets succeed in obtaining such technology at the present time, I fear the adverse impact on U.S. security will be especially pronounced. This is due to the fact that, in addition to the *direct* effect in enhancing Soviet military capabilities that will ensue, Moscow could benefit from three, *indirect* but synergistic phenomena of this era:

- o First, U.S. investment in its own research and development technology base is likely to be significantly reduced as a result of defense budget cuts.
- o Second, also as a result of those cuts, this country's ability to redress the impact of improvements in the quality of Soviet forces will diminish greatly. The Committee will recall that the cost to the U.S. Navy of restoring its edge in anti-submarine warfare following Toshiba's $18 *million* sale of quiet propeller manufacturing technology has been estimated to be upwards of $15 *billion*. Clearly, we can ill afford such unnecessary additional defense burdens at this time.
- o Finally, the United States is in the process of negotiating a series of arms control accords with the Soviet Union. If past experience is any guide, such agreements will impose significant constraints on U.S. abilities to introduce new military technologies. Examples of such constraints may be found in the START Treaty's likely limitations on the performance of air-launched cruise missiles and its oblique -- if not explicit -- limits on pursuit of the Strategic Defense Initiative.

Taken together, these direct and indirect effects threaten to endanger the robustness and decisiveness of the technological advantage traditionally enjoyed by the U.S. military. I believe this is the backdrop against which decisions should be made to liberalize East bloc access to sophisticated Western dual-use technologies.

Eastern Europe is Still Part of the Technology Security Problem

As I mentioned earlier, I think improved access to Western high technology is very high on Gorbachev's agenda. This can be seen in the priority he has attached in his diplomatic and economic forays into the West to encouraging the dissolution of COCOM. It can also be discerned in the redoubled effort being made by the Soviets -- both directly *and through their East European allies* -- to steal or acquire illegally a variety of controlled technologies.

The unhappy truth of the matter is that, despite the laudable popular demands for reform in the Soviet bloc and -- to varying degrees -- governmental steps being taken to satisfy those demands, **every one of the East European nations continues to be a member of a hostile alliance.** As a result, the close collaboration between the military, intelligence, and security agencies of the Soviet Union and those of its allies in Eastern Europe, all of which remain in the hands of local communists, continues apace.

A number of authorities on the subject have recently noted that, if anything, anti-Western activities (e.g., espionage and technology theft) are now being undertaken by Moscow's allies in Eastern Europe more aggressively than before. To cite but a few:

- On 14 November 1989, Senator William Cohen, co-chairman of the Senate Intelligence Committee, said on the Senate floor: "The intelligence services of Poland, East Germany, Czechoslovakia, Bulgaria, Hungary, and Cuba continue to conduct intelligence operations in this country, not only to serve their own national interests, but also as surrogates for Soviet intelligence. This appears to be one field where countries such as Poland continue to serve Soviet interests that directly injure the national security of the United States."

- In remarks before the National Press Club on 29 November 1989, William H. Webster, director of the Central Intelligence Agency said: "Around the world, our stations are reporting more aggressive action [on the part of the Soviets and their allies] and a more robust intelligence collection effort, more effort to recruit our embassy and intelligence personnel than we have seen for a long time."

- John C. Whitehead, former Deputy Secretary of State, said in an article published in the New York Times on 29 December 1989, "We've often found that changes have taken place in the East bloc countries without any similar changes taking place in those countries' foreign intelligence gathering networks."[1]

- This same article concluded that "Despite a democratic revolt that has shaken Communist rule in Czechoslovakia and five other Eastern bloc states, those nations' espionage agencies have not slackened their vigorous efforts to steal Western technology and military secrets, often at Soviet direction....The KGB appears in some cases to have stepped up its "tasking" of Western bloc agencies for specific missions against Western targets."

Accordingly, the question is not: Could the East Europeans revert to being handmaidens of the Soviet campaign to acquire strategic technologies? *They have not stopped playing this role to date and we would be naive and irresponsible to believe otherwise.*

Dubious East European Assurances about Technology Safeguards

This is not to suggest that assurances being offered by East European governments that Western high technology will be safeguarded are necessarily disingenuous. To the extent that bonafide democratic reformers are pressing for such technology -- and I believe they are less insistent on this form of assistance than are others whose credentials as reformers and motives are more suspect -- they may simply not know how serious the technology security problem is. They certainly do not appreciate how powerless they are to prevent diversions under present circumstances.

Several anecdotes serve to illustrate this problem:

- On 17 January, the head of Hungary's state security service, Major General Jozsef Horvath, was forced to resign when members of the opposition discovered that agents of his organization were still intercepting mail and using telephone taps and informants against individuals and opposition groups.[2]

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[1] "It's Still Business as Usual for Spies, Even as the Eastern Bloc Rises Up," New York Times, 31 December 1989.

[2] As reported in a Radio Free Europe/Radio Liberty Daily Report, 17 January 1990.

- The German government of Hans Modrow nearly fell a few days ago over the reports that he was reinstituting the hated "Stasi" secret service. Despite the sacking of its headquarters in East Berlin and assurances that the organization would not be resuscitated until after the April elections, there is ample reason to be suspicious of the actual status of the Stasi.

- Czechoslovakia's spy agency, the Office for the Protection of State Secrets, continues to operate. It has long been derided for being the "two-Czech" service: Its agents are said to get one check from Prague, and another from their real bosses in Moscow.

Indeed, as the New York Times report noted above disclosed, notwithstanding government shakeups, reform agitation and governmental disclaimers, the East European intelligence services are "demonstrating an increasingly sophisticated ability to fine-tune their technology acquisition requirements." (It is worth noting parenthetically that they are almost certainly exploiting as well the marvelous opportunities afforded by the new international environment to infiltrate active intelligence operatives and so-called "sleepers" into Western societies and industries.)

Under these circumstances, it would be wholly unjustified to think that diversions of significant dual-use technologies made available to Eastern Europe will not find their way to Moscow.

How to Protect Against the Loss of Sensitive Technologies through Eastern Europe

Unless and until changes occur that have not been in evidence to date, namely the rupture of the Warsaw Pact and the complete severing of its sundry military, security, intelligence and espionage relationships (involving among other things the complete removal of all Soviet military and KGB forces from these countries), we must continue to operate on the assumption that such relationships will be used to serve Soviet technology theft functions.

For the interim, we should help with the upgrading of Eastern Europe's industrial base on a selective, disciplined basis. I believe , however, *that our doing so does not require the transfer of state-of-the-art dual-use technology*, the most important of which is controlled by COCOM. Indeed, **a number of reformers have made clear their misgivings about having Western assistance take the form of high technology sales**; they appreciate it is not essential to their economic recovery, that it can result in Soviet pressure for diversions and that it will likely displace other forms of assistance that are more needed and less susceptible to abuse.

We at the Center for Security Policy would like to propose an alternative approach that promises both to assist the East Europeans in an appropriate manner and to serve U.S. *domestic* as well as foreign policy objectives. Machine tools offer an illustration of how such an approach might work.

It is estimated that 90+ percent of U.S. industry is utilizing machine tools with accuracies at or inferior to the COCOM standard of *plus-or-minus 10 microns*. The impulse for greatly relaxing that standard -- reportedly down to *plus-or-minus 2.5 microns* -- comes not from a determination that such machines are **indispensable** to the economic revitalization of East Europe. Rather, it is driven by the **quality of machines West German manufacturers** have to sell. *The Germans simply no longer make machines with the relatively poor performance largely used by U.S. industry.*

Under these circumstances, there may be an alternative to selling the East Europeans state-of-the-art machine tools whose potential for militarily significant abuse is considerable, while at the same time encouraging the necessary retooling of the American industrial base. We would urge Congress to consider enacting legislation that would provide tax incentives for U.S. industry to replace existing equipment that conforms to current COCOM standards. Such equipment could then be provided to East European end-users identified as potentially significant contributors to the economic and political reform and revitalization of their respective nations.

Such an approach offers a **winning solution** for everyone -- everyone except the Soviets, that is: Manufacturers of controlled technologies could obtain new, "safe" markets for their sensitive equipment. Legitimate entities and enterprises in Eastern Europe that contribute to the genuine transformation of their respective economic and political systems could get access to technology that would greatly improve the quality and efficiency of their manufacturing processes -- without jeopardizing Western security interests. And the U.S. taxpayer, who is inevitably going to be stuck with a substantial portion of the bill for bailing out the failed economies of Eastern Europe can at least have the satisfaction of knowing that this is being done in a *targeted* way, one with the ancillary benefit of doing something for the health of our own economy -- in contrast to the present approach of providing outright grants.

The Future of COCOM

In my view, the most serious threat to COCOM arises not from the greed of German machine tool manufacturers and their counterparts in other industries and other countries who are appear bent on making sales irrespective of the security consequences of doing so. These are often cited as sources of pressure that, unless appeased by liberalization of the current export control regime, will seek to destroy that regime altogether.

Instead, I think the real threat to COCOM -- and to the collective security it exists to safeguard -- comes from words and actions of leaders of the West, first and foremost those here in Washington. Unless we are able to articulate a clear and consistent vision of the threat the Soviet Union continues to pose, there is little reason to believe that COCOM (or for that matter NATO and Western defense budgets and establishments) will be properly sustained. President Bush's frequent assertion of his commitment to help Gorbachev succeed, to be a "partner" in perestroika, is *precisely the wrong signal* to send if such institutions and capabilities are to be preserved. As long as this signal is the preeminent -- not to say exclusive -- one being sent from Washington, I believe no amount of salami-like erosion in export controls is going to "save" COCOM.

I am convinced that Congress can -- and should -- play a helpful role in defining and conveying a sensible vision of the continuing challenge posed by the USSR. For a model, we need look no further than to the initiative taken by Congress in 1987 by which Toshiba was put on notice, in the aftermath of its deplorable, illegal technology transfer to the Soviet Union, that its future access to U.S. markets would be jeopardized by such behavior. We should offer the Germans and others a similar choice: Our *hard-currency, real market* versus the *possibility* of sales to Eastern Europe and the Soviet Union, probably on credit at that.

Needed Changes in the Technology Security System

In addition, I believe several changes are urgently needed in the way U.S. and Western technology security is being handled.

First, a greater effort clearly needs to be mounted to enforce COCOM restrictions. In early October, Ambassador Alan Wendt of the State Department and the director of the Defense Technology Security Agency, William Rudman, made an important tour of European capitals. Its purpose was to demonstrate the serious problem arising from lax enforcement of COCOM guidelines by member nations.

One striking example of this problem is the fact that, since 1983, over 6,000 COCOM-embargoed machine tools were sold to the USSR, nearly all of them funneled directly to projects run by the Soviet Military Industrial Commission. Half of those 6,000 machine tools were of West German origin. The machine tools allegedly sold by the Italian firm, Olivetti, to a Soviet aeronautics factory where they were used to build the YAK 41 fighter-bomber.

Given this sorry track record, I am very leery of commitments now being offered that enforcement will improve *if only the COCOM list is shortened*. In fact, I would seem to me that a prerequisite for altering the list of controlled items in ways that entail assuming additional security risks (e.g., the relaxation of controls on highly accurate machine tools) should be a demonstrated willingness and ability by all member nations to enforce *existing* controls.

Second, there is an urgent need for Congress to correct a problem that has arisen as a result of the Commerce Department's interpretation of an amendment to the 1988 Omnibus Trade bill designed to modify the Export Administration Act. The original intent of the amendment, you will recall, was to ensure that due consideration was given to "foreign availability" in determining the utility of retaining certain export controls.

The Center has, in a series of papers which I would ask permission to have inserted in the record at the conclusion of my testimony, established that instead of serving this sensible purpose, the amendment has become a device for the wholesale and irresponsible decontrol of extremely sensitive technologies. In a case governing advanced personal computers last summer and the recent decision to decontrol virtually all wire-bonders, the Commerce Department is allowing the most flimsy of evidence to serve as grounds for a finding of foreign availability -- even where the evidence is contested by the Defense Department and the intelligence community.

I urge the Committee as it takes up the matter of the reauthorization of the Export Administration Act to establish the requirement for the consent of the Secretary of Defense on such findings. This is a vital check on the sort of arrogant and high-handed decision-making that has come to characterize recent Commerce Department decisions in this area. *Ironically, it is precisely the sort of prescription that Commerce sought last year in the notorious FSX controversy when it was at the receiving end of similar treatment from the Defense Department.*

Finally, I believe the Committee must look into the whole manner in which the executive branch is staffing and acting upon technology security issues. My own conviction is that the only way to ensure that all agencies and all points of view are properly represented in these sensitive decisions is to ensure that an effective interagency mechanism is in place and rigorously utilized.

Thank you for this opportunity to contribute to the Committee's deliberations in this vital national security area.

Chairman ROSTENKOWSKI. Mr. McNeill.

STATEMENT OF ROBERT L. McNEILL, EXECUTIVE VICE CHAIRMAN, EMERGENCY COMMITTEE FOR AMERICAN TRADE

Mr. McNEILL. I am Bob McNeill with the Emergency Committee for American Trade.

Being the last witness on a panel, on a morning like this, leaves very little for one to say that already has not been said. I, therefore, very briefly would like to cover three of the areas that are contained in the statement that I submitted for the record.

The first has to do with the Jackson-Vanik amendment. I would like to address my comment primarily to Mr. Downey's question addressed to Mr. Kendall and Mr. Murphy, and that is that it is the position of the U.S. business community that repeal of the Jackson-Vanik amendment is the first preference.

Very clearly, the business community would prefer to see repeal because that would provide a certainty that a waiver period does not. Certainty is something very much desired by business persons who are going to invest money on behalf of their shareholders in any country in the world.

It is particularly risky to invest in countries that have nonmarket economies, and the waiver period currently contained in the Jackson-Vanik amendment of up to 3 years certainly seems to be a very short period.

So, perhaps in the wisdom of the Congress, if repeal of the amendment should not be in order, perhaps an amendment of the Jackson-Vanik amendment extending the period of the waiver authority would be something that would be very much desired, something beyond 3 years.

As Mr. Murphy indicated, it sometimes takes from 1 to 5 to 6 years, simply to initiate and get a project on stream.

The second issue I would briefly like to talk about is export financing, that also has been discussed by my colleagues on this panel and by Mr. Kendall and Mr. Murphy. We are very upset in the business community at the President's budget request submitted to the Congress yesterday for $500 million direct credit authority for the Export-Import Bank.

That is $112 million less than the credit authority that was available in fiscal year 1990 for the Export-Import Bank.

Policy pronouncements have been made that the administration would like to use the authority of the Export Bank to provide, I believe, up to $200 million in assistance to Panama, and a similar amount of assistance to Poland.

Those two amounts add up very nearly to the total of $500 million in fiscal year 1991 credit authority recommended in the President's budget. So the Export-Import Bank, the Stevenson amendment aside, does not seem to have the resources that are remotely needed, not only to help finance normal commercial exports, but to finance United States exports to the countries of Eastern Europe.

Another export financing issue that is of great concern to the business community is the practice of providing mixed credits, whereby our foreign competitors provide export financing packages containing commercial elements, that is a commercial loan, together with a foreign aid element may be a Government grant.

By the utilization of this device, our foreign competitors have gained business that otherwise could be available to Americans.

The Export-Import Bank itself has an authority to provide mixed credits, but again, a very limited authority.

In Eastern Europe, Japan already is negotiating loans that will be tied to the purchase of Japanese products, perhaps involving mixed credits.

Finally, I would like to comment on export controls. This is an area that is terribly important in respect of our ability to compete, not only in Eastern Europe, but in Western Europe as well.

Our export control list in the United States tends to be longer than the comparable list of our trading partners, and particularly a longer export control list than that of the COCOM

As Europe moves toward implementing the regulations that Mrs. Johnson was talking about earlier and develops a common or harmonized export control policy part of EC–1992, it's extremely likely that the export controls. list maintained by our European colleagues will be considerably diminished.

It's incumbent upon the United States, if we are to enhance our competitiveness that we work out arrangements with the European Community whereby there is a commonality in export control, both as to policy and as to the types of items that will be controlled. Absent that, the United States is going to be in a very disadvantageous position.

There is a rush in Europe now, to liberalize export controls. East Germans shopping in West Berlin are bringing back home with them lap top computers for example, that contain technology that our export control list prohibits us from shipping.

There is a real risk that current export control policy is going to put the United States in a very disadvantageous position unless the Congress and the administration amend the current statute to enable us to be more liberal in the application of our export control law.

Thank you.

Chairman ROSTENKOWSKI. Thank you, Mr. McNeill.

[The statement of Mr. McNeill follows:]

Emergency Committee for American Trade 1211 Connecticut Ave Washington DC 20036 (202) 659-5147

STATEMENT OF ROBERT L. MCNEILL, EXECUTIVE VICE CHAIRMAN, EMERGENCY COMMITTEE FOR AMERICAN TRADE, BEFORE THE WAYS AND MEANS COMMITTEE HEARING ON U.S. RELATIONSHIPS WITH THE SOVIET UNION AND EASTERN EUROPE

JANUARY 30, 1990

We in ECAT appreciate the opportunity to offer comments on U.S. trade with the Soviet Union and the countries of Eastern Europe. Whatever the reasons for the epochal changes in those countries, one of them has to be the policies that the United States and its allies have pursued over the past several decades. So too must be the working examples of the Western democracies that citizens of the Eastern European countries were able to witness.

Ongoing changes in the Soviet Union and Eastern Europe are the very ones that we have encouraged, among them the move away from public to private ownership of the means of production and the increased respect for basic human rights, most importantly the right to choose those who will govern as well as the means of governing.

The political and economic reorganization of Eastern Europe is a profound happening with very significant implications for the United States, including its business community, and for the future organization of Europe. We believe that the Administration's response welcoming these events is the right one.

As appears to be the case, the U.S. response should be on a country-by-country basis in recognition of the differing speeds with which these countries are proceeding with reform. At the moment, for example, more U.S. assistance to Poland and Hungary would seem appropriate in light of the wholesale overhaul of their economies and political systems now under way. The task of reforming political systems and in restructuring whole economies is herculean. To get what the West has and what the people of Eastern Europe want will be achievable only after a long and likely painful period of time.

U.S. companies, including several ECAT members, are actively establishing business relationships in Eastern Europe and in the Soviet Union. So too are businessmen from around the world. This is good for the countries where foreign investments will be made. Their economies will be enriched and their workers' welfare will be enhanced.

Jackson-Vanik Amendment

Of considerable concern to the members of ECAT and to the U.S. business community as a whole is the Jackson-Vanik amendment. We strongly urge cooperative action between the Administration and the Congress in exercising the waiver authorities contained in the amendment so that most-favored-nation tariff treatment (MFN) can be granted to those countries whose emigration policies are determined by the President to meet standards contemplated in this law.

Pursuant to the waiver authority of the Jackson-Vanik amendment, we urge the Administration in cooperation with the Congress and the business and labor communities to negotiate as quickly as is feasible the commercial agreements that also are required as a condition of granting MFN.

Without waivers of the Jackson-Vanik amendment -- and its companion Stevenson amendment to the Trade Act of 1974 that prohibits the extension of government credits to the Soviet Union, except for agricultural loans from the Commodity Credit Corporation -- U.S. businessmen will be at a distinct disadvantage vis-a-vis their foreign competitors in the Soviet Union and in Eastern Europe. Even though the waivers might have limited initial economic impact, without them the U.S. business community will find it much more difficult to negotiate commercial arrangements since foreign authorities might prefer to do business with countries without Jackson-Vanik type amendments and the uncertainties that they cause.

Certainty is of utmost importance to businessmen contemplating direct investments anywhere, but particularly in new and uncertain environments. From this perspective, the natural preference of the business community would be to see a repeal of the Jackson-Vanik and Stevenson amendments from the statute books.

Short of such a repeal, we would urge the Congress to consider an amendment of the basic statute to allow for waiver authorities beyond the current limitation of three years and without the necessity for the annual reviews and determinations presently called for. The prospect of an on-and-off spigot treatment in the critical MFN area is an absolute discouragement to the establishment of business ventures in any instances where the U.S. tariff level is a factor in the decision to enter into a business arrangement.

There are two other policy areas that I would briefly like to discuss. One deals with government export credits and the other deals with the critical area of export controls.

Export Financing

A significant financial step just-noted above would be either repeal of the Stevenson amendment or the use of its waiver authorities so that credits could be provided for non-agricultural U.S. exports to the Soviet Union.

Even absent the Stevenson amendment stricture, the question of government financing of U.S. exports is a significant one. For the past several years, the Eximbank, along with others, has been on an extremely tight budget leash. While not yet public, it is expected that the President's budget request for the Eximbank's direct lending activities in FY 1991 will be about $600 million. Even under the worst of export conditions, that is an inconsequential amount. It becomes even more so in light of proposals to use Eximbank resources to extend credits to Poland and to Panama.

I mention the export credit issue since it directly bears on the subject of this morning's hearing.

We would like to take the opportunity of this hearing to call on the Administration to consider establishment of an Administration Task Force with participation of the Eximbank, OPIC, USTR, Commerce, State, Treasury, the foreign aid Administrator and perhaps others to evaluate the economic needs of Eastern Europe countries that may be eligible for government assistance and to report to the Congress both as to the needs and the resources required to meet them.

Mixed Credits

One area of great contentiousness between the United States and its allies is the use of "mixed credits." These are credits utilizing a commercial and a foreign aid component. Mixed credits are used widely by our competitors. The United States has recently begun to provide mixed credits in order to discourage our competitors from using them to-gain unfair competitive advantage over U.S. exporters.

There is concern in the U.S. business community that our foreign competitors for business in Eastern Europe may well prevail on their governments to use the mixed credit device as a means of gaining competitive advantage.

We are pleased that U.S. officials will seek agreement at the April 1990, meeting of the OECD Ministers on limits concerning the use of mixed credits.

Export Controls

Although, as in the case of export financing, the Congressional responsibility for export controls rests with other committees, export control policy will be a significant determinant of the level of U.S. business in the Soviet Union and in the countries of Eastern Europe as well as in Western Europe itself.

U.S. export controls are imposed to deny the Soviet Union and its allies access to products and technologies that will enhance their respective military capabilities. U.S. export controls are also imposed from time to time as an expression of dissatisfaction with public policies of other countries. When the Soviet Union several years ago, for example, was exercising repressive action against the so-called "refusniks," the United States imposed foreign policy export controls prohibiting the shipment of Caterpillar Co. equipment that was being used by the Soviets to dig a major pipeline to carry natural gas across the Soviet Union. As a result, the Soviets switched from Caterpillar to its major world competitor, Komatsu, and practically wiped the Caterpillar Co. out of doing business in that part of the world.

Our allies also have export control policies. Together with our allies, we have created a multilateral export control system that is administered through a cooperative organization known as CoCom. Through CoCom, we and our allies agree on common lists of items and technologies that are not to be shipped to the Soviets and their allies. In cases where the CoCom allies cannot agree as to items and technologies to be controlled, member countries are free to control them unilaterally.

The CoCom system generally works well. The qualification is that the U.S. export control list is often much longer than the agreed CoCom list. The consequence is that U.S. firms are denied business opportunities that their foreign competitors are free to fill.

U.S. export control law also applies to the foreign subsidiaries of U.S. firms. These subsidiaries are prevented from exporting the items and technologies that are on the U.S. control list even though they may not be on either the CoCom or the host country export control list, and even though the subsidiaries are under the political jurisdiction of the host country.

In addition, U.S. export control law applies to U.S. products and technologies wherever they are used and by whomever, so that foreign companies with absolutely no corporate affiliation with U.S. firms are subject to U.S. export controls. The extraterritorial application of this U.S. law is much resented abroad.

Two major changes in Europe bring the export control issue front and center -- the EC 1992 move toward internal market integration and the revolutionary and historic changes in Eastern Europe. Both pose fundamental challenges to the U.S. and to the multilateral export control systems.

In its move toward internal market integration the EC has yet to decide how to handle export controls. The two possibilities are to move to a new EC system or to harmonize existing national export control systems.

Because of the national security and economic importance of this issue, it is important that the United States collaborate within CoCom and with the EC toward a multilateral export control system that will be compatible with the creation of an integrated EC market. That market is potentially the West's largest. To the extent that the United States and the EC can agree on a common system, it will be possible to eliminate all U.S. controls for EC countries and thus put U.S. firms on an equal footing with EC firms in the European market insofar as export controls are concerned.

If the United States and the EC do not agree on a common export control policy, the prospect for commercial losses to U.S. business could be great, as could the prospect for political and economic conflict. Should the United States, for example, maintain a much more restrictive export controls list than does the EC, it would be quite likely that the United States would find itself applying unilateral export controls on shipments of EC subsidiaries of U.S. firms as well as on shipments of European firms whose products contain U.S. components.

While it is almost certain that there will be a very substantial relaxing of current European export control policies, the issue is whether the Europeans will accomplish this in cooperation with the United States or whether the Europeans will do it alone.

Indeed, export control relaxation already is occurring in Europe. East Germans visiting West Germany, for example, are purchasing small computers and other high tech products that are on the U.S. export control list and simply taking them back home to East Germany at the end of the visit without border inspections or other inconveniences.

Export control liberalization is also moving at a significant pace in the United States. On January 19, 1990, for example, a decision was made by the National Security Council to seek CoCom agreement for liberalizing export control restrictions on shipments of advanced computers, telecommunications equipment and sophisticated machine tools to Eastern European nations. This was done not only to assist the development of these nations but also in response to the view of our European allies that the crumbling of Soviet rule in Eastern Europe requires the West to make sweeping changes in export control policies.

U.S. support for liberalizing the above controls is contingent on the Eastern European countries instituting strict controls systems to insure that the products and technologies involved are not used either by themselves or by the Soviets for military purposes.

The current administration by the United States of its export control laws is most harmful to the competitiveness of U.S. companies. Unnecessary controls limit their trade with non-communist countries by prohibiting sales not only of the U.S. parent but also of its foreign subsidiaries. This is because U.S. controls are more restrictive than those of our free world competitors.

I did not mean to dwell too long on the subject of export controls, but I do want to impress on this Committee and on the Congress that the export control issue is one of those fundamental issues that will determine how well the United States and its allies will be able to work together to encourage and assist in the reform efforts in Eastern Europe and the Soviet Union.

The preservation of the multilateral export control system as it applies to the Soviet Union and Eastern Europe requires the agreement of the United States and its allies on the de-licensing of products and technologies that are commonly available among them or from other countries not party to the CoCom system.

The redesign of the architecture of Europe poses a great challenge to the United States and its allies. On a country-by-country basis, the United States must calibrate its response to change and to foster further progress. It must also work cooperatively with our allies in developing common programs and responses.

Thank you for your patience.

Chairman **Rostenkowski.** Are United States firms as well positioned to move into the Soviet market as their counterparts in Europe, Mr. Jenkins?

Mr. **Jenkins.** The easy answer to that, Mr. Chairman, is no. I think the barriers that we pointed out in our statements throughout the morning are illustrative of the problems that we unilaterally face compared to our competitors.

Chairman **Rostenkowski.** You know, what is amazing about that really is that in my private conversations with most of the new emerging Eastern European nations, they want us to come in; and it's amazing that we are so slow to make the movement. Then again, we can blame the redtape that our Government provides with respect to trade relations.

We were in Hungary last year, and it was amazing to me that one of the representatives sitting across the table from us was critical of our business practices. It was almost as though we are not hungry enough, we aren't in there competing.

The old massive salesmanship is gone as far as the American entrepreneur goes. The Swedes, the Germans, the Japanese are quite concerned with the business relationships. We come in and lay our wares out, display what we have available, and then we pack up and go home and expect a telephone call while our trading partners are there using the old salesmanship tactics. What do you think of that reaction on the part of a potential trading partner?

Mr. **Jenkins.** If I can have a followup, and then I will stand down.

Congressman Cardin made that same point about where is American business in this situation. As American businessmen with our limited assets, we have to look at the world as a marketplace. Why would an American corporation move into the Soviet Union today with all of the legislative barriers that are there, when we can go to Mexico with a Treasury Department guarantee that they are not going to go down the tubes?

And now we have Panama and the CIB. You in Congress have set priorities and standards and limitations and barriers, which encourage or discourage us from moving into a market.

And my appeal this morning, sir, is that you move on those barriers which are discouraging and chilling our interest in Eastern Europe and the Soviet Union.

The Japanese, for example, do not face those same legislative barriers.

Chairman **Rostenkowski.** Any other comment?

Mr. **Robinson.** Mr. Chairman, the other side of that coin, however, is this: When we look at the way our competitors do business in the Soviet Union and Eastern Europe, we cannot deny the fact that they are heavily subsidized by their governments on many occasions.

For example, foreign business executives are often accompanied by heads of state from their governments, and you have a public/private sector partnership in expanding trade that is very formidable.

Now, the question is, Should we get into the subsidies business ourselves and involve ourselves in what amounts to a subsidies war with our allies?

I think the preferred solution would be not to go down that road, but rather to seek alliance agreements that would remove the subsidized elements that are penalizing our taxpayers and instead get into a trade mode with private risk capital as the determining factor in competition for business.

Mr. **Milosh**. If I could comment.

We talk in terms of generalities, but I would say that it depends on what kind of business and what level you are talking about.

I think an American businessman, based on the huge market that exists here in the United States, will search out the best possible business deal and the best prices he can world over, as long as he has market access. He will be there, when we are talking about imports, which is one-half side of the coin.

When we are talking about exports, especially to Eastern Europe, you are talking about state type of purchasing; and here, especially in the Soviet Union, you have to have the backing of your Government and support in terms of financing export controls and the like, and that's essential on the export side for the state planned economies.

The important thing is that Eastern Europe is changing, and it's changing rapidly, not only for the importer who can make a difference now because market access is coming about, but similarly for the exporter, which is the other side of the coin.

He now has market access, and if we just give them enough support, he will be able to do what is necessary. Again, the Soviet Union does remain a problem for the export considerations that Mr. Robinson has talked about, and for export controls considerations and because it's still a planned economy, so it's still possibly a good risk for the large companies that can afford it.

Chairman **Rostenkowski**. Mr. Gibbons.

Mr. **Gibbons**. Mr. Chairman, I don't have any questions. I just want to make it clear that I support generally what the panel has said and commend them for their coming here and telling us about the problems.

My experience here on this committee has been that the problem is downtown in the White House. We cannot get any cooperation from that bunch. You know, every time I tried to move last year, the response was "no, no, wait, wait, wait, wait. We have got some plan. We got some plan." You cannot get anything out of them.

I don't know whether it's somewhere in the State Department, it's somewhere in the National Security Council, it's somewhere in the USTR, or the Treasury Department. Everybody comes at you every time you talk about these things.

Let me ask you a question. Has the administration consulted with any of you yet about the trade agreement with Russia?

Mr. **Jenkins**. Yes.

Mr. **Gibbons**. How extensive has consultation been?

Mr. **Jenkins**. Well, maybe more extensive than they preferred, but I had several conversations with people in the administration about what should and should not be in the agreement.

Mr. **Gibbons**. How close do you think they are to getting ready to negotiate an agreement?

Mr. **Jenkins**. Very close, I think, Mr. Chairman. I know that members of your staff also consulted with us about this, or with a group of business people here in town.

Mr. **Gibbons**. I don't want you to include my staff because I know they have been consulting, but we haven't seen much in the administration.

Frankly, I am surprised that they have consulted any of you about a trade agreement. Have they actually called you in or have you just volunteered some stuff for them?

Mr. **Jenkins**. Well, who made the first move isn't the critical factor. We were listened to and banged away at them and made the same points to them that we are making to you.

I think there is an awareness. There certainly is an indication that the administration looks upon the trade agreement negotiations and the summit in the late spring as a target, a trip wire; and they are going to have to meet it.

And the opportunities there, I would hope that in fact your staff, without waiting for being invited, will lean on USTR, which is who is going to be doing the negotiating.

Mr. **Gibbons**. We have been trying to lean on them, I tell you, for a couple of years on this thing. We couldn't get anything on them on the sugar program. We can't get anything on this. And all we get is wait, wait, wait.

I am sick and tired of waiting, frankly.

Mr. **Jenkins**. I think this time——

Mr. **Gibbons**. Nothing I can do, though. I have to wait on them. But I am sick and tired of waiting. Yes, sir.

Mr. **Milosh**. In our case, we had to make the call.

Mr. **Gibbons**. Yes. That sounds familiar.

Mr. **Milosh**. And I don't think that there is enough put on the table now that we can really focus in on.

Mr. **Gibbons**. What I point out is that the President promised Gorbachev that he was going to have MFN by summertime. That is the way I read the statement, and frankly, I don't see any groundwork having been done here or in the private community so far.

There is a big legislative step to get done, and I don't see that they have done the work yet.

Mr. **Jenkins**. Well, in my conversation with the USTR people working on the trade agreement, they have addressed the MFN question in some detail. My concern is that they are looking at that first step as the only thing they are going to do in the short run, and my hope is that Congress will reach out, as Dick Schulze said, for a higher package.

I think the moment is historic, and I think it would be a pity if we don't do everything we can to incentivize the reforms away from NME economies from Eastern Europe at this time.

And I can remember when you effectively put the blow torch on us when I was in the administration, Mr. Chairman, and I hope you are doing it again in this particular instance.

Chairman **Rostenkowski**. Anybody else have any comments?

Mr. **McNeill**. I was going to say, Mr. Chairman, that we, too, are having discussions with USTR on what might be in a commercial agreement. I believe that Ambassador Carla Hills fully intends to have an agreement in hand by the spring summit meeting.

It appears to be a priority objective for her, and I believe that everything that is feasible is being done. Whether in the end it will be enough is a conjecture at this point, but they are working on it.

Mr. ROBINSON. Mr. Chairman, I think that we have to observe the process that was reportedly agreed to by the President, which involves first codification in Soviet legislation of emigration as a right, not a privilege.

To my knowledge, that legislation within the Soviet system has not been concluded at this time.

Mr. GIBBONS. That does not stop us from planning.

Mr. ROBINSON. No. I think that planning is taking place to capitalize on that development within the Soviet Union when it occurs. But the question that I have on this matter of a timetable is what about implementation? That is, the words of codification need to be matched by the deeds of implementation—which is in turn why you presumably should have a several month track record to ensure that this new Soviet legislation is indeed, going to represent an effective right of the Soviet people.

The other concern I have on the trade agreement is that there may be a scaled-down version in the offing as a result of time limitations. That is, the Soviets, for instance, receiving MFN, possibly even restored access to Eximbank credits, a favorable settlement on defaulted Czarist and other debt to the United States, but not having sufficient time to conclude provisions that protect intellectual property rights and offer investment protection for United States companies in the belief that there will be a follow on bilateral investment treaty that could handle those matters.

In short, the problem there might be that the Soviet Union is getting a number of items provided that they have requested, without addressing all of the agenda of benefits for the United States side.

Mr. JENKINS. That is one of the things we urged in our consultation. I agree with Roger. I think the investment tax agreement, the investment tax agreement which some people foresee as a subsequent agreement, should be the large part of it, the guts of it really should be included in the trade agreement.

There is no reason to have that held back for a second subsequent agreement. And if we don't get these considerations built into the trade agreement, we may well go on for 2 or 3 years without them, and that will still have the same chilling effect on effectively doing business both ways.

I think the administration has heard us on this; they do hear you much better, sir.

Mr. GIBBONS. Thank you.

Chairman ROSTENKOWSKI. Mr. Pickle.

Mr. PICKLE. Thank you, Mr. Chairman.

You gentlemen seem to indicate that all of you are in favor of the most favored nation approach, and that seems to be the general attitude all morning, and yet each one of you in your statements, many of them referring back to what Mr. Murphy had said, said, yes, it ought to be done.

But you have also said it with some reservation, it seems to me, and, that is, you think we ought to have a most favored nation if there is a track record established first about either immigration or trade, and certainly you have reservation about the excess of export/import.

Now, I take it then that you would favor the most-favored-nation status if the Soviets would not have access to the export/import in an unfair manner, and that you would require also the repeal of the Stevenson and the Byrd amendment.

Now, are you saying to us that you think most favored would be appropriate if those sections were repealed and if you could limit the Soviet access to the export/import?

Are you saying that is a condition of this most-favored approach?

Mr. JENKINS. I am not, sir. I think Roger——

Mr. PICKLE. Mr. Robinson seemed to indicate that very strongly.

Mr. JENKINS. I don't share that. I think the track record he speaks of for credibility has reached the point where we can't absorb the flood of emigrants. I am reminded of when Senator Jackson met Deng Xiaoping, and Deng looked up at Jackson and said, "Oh, you are the famous Senator who is interested in immigration. How about 2 million in Seattle on Monday morning?" That was obviously was meant as a joke. The fact is, we are dealing now with a flood of immigration from the Soviets and Eastern Europe, which is only going to get much stronger and worse.

I don't think the track record could be any more credible and that we could absorb it. I do agree that the codification is a prerequisite and I assume we will see that happen. If it does not, I think we ought to hold it out there.

Mr. PICKLE. I am just trying to establish when you make reference to codification, that is, you would be for this if you had one, two, three, four taken care of first.

Mr. JENKINS. That is right.

Mr. MCNEILL. We support the vigorous use of the Jackson-Vanik amendment waiver authority to provide MFN tariff treatment and we are also saying that we support repeal of the Stevenson amendment, which prohibits the extension of credits, except for CCC, Commodity Corporation Agricultural Credits, we support the elimination of the Stevenson amendment so that commercial credits can be provided.

We are very clear on that position.

Mr. ROBINSON. If I may, just to make a point. I think it is more than the numbers of people who are emigrating. I agree that the number of emigrants from the Soviet Union is most impressive, but obviously this is a more complex issue than that. There are long-time "Refusniks" involved, there are those individuals who have been denied emigration because of a fraudulent assertion of past access to state secrets, there is the recent Soviet decision to devalue the exchange rate of the ruble by tenfold for tourists, but without caring about the other side of the coin, which is the restrictive effect of drastically reducing the amount of hard currency that Soviet citizens can obtain when departing the Soviet Union, limiting them to about $30.

These, to me, are the kind of hidden impediments, the more subtle slippage that require a track record of performance to assure their removal.

On Eximbank, unlike MFN that can be tied to emigration, deciding access to Eximbank requires more financially oriented criteria.

I don't just think emigration performance is enough to decide. Overtime, you have possibly hundreds of millions, even billions of dollars involved in Eximbank decisions.

Mr. PICKLE. Mr. Robinson, you indicate to me that you feel that how we handle the accessibility of Export/Import Bank is more important than the Jackson-Vanik Amendment, and that you list five different things that concern you, the loans, and the other aspects, but you are saying that that is more important than the Jackson-Vanik.

I think that is important that we consider that. I assume that you are saying that we ought to reach an accommodation in those different areas and not that you wouldn't be for a most favored nation unless you were granted all those things, I don't know that we could give you everything like that and also try to limit the imports into this country. I don't think you can have it both ways.

But I hope in your discussion with the administration you don't try to say yes, we want this, and posture that we got to have most favored and then say, but we will take it only on conditions.

This committee is going to have to get it in a broader way, too. I thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman.

Mr. McNeill, I was interested in your comments about the mixed credits being used by our competitors. I was wondering if you could just expand a little bit as to which countries are most actively involved in using mixed credits and in what form they are taking?

Mr. McNEILL. The European countries tend to use export credits, particularly the French, and also the West Germans. Japan also utilizes the technique of mixed credits. Let me illustrate an example of a mixed credit, perhaps not a real one, but it will be very close to I think what a real example might be.

Let us suppose that Brazil wants to develop its infrastructure by building an electrical generating facility involving the use of generating power equipment and related equipment.

The French might say, look, we will provide the financing for that total project. Assuming the project has a cost of $1.2 billion, we will provide you in the form of grants $300 million from our foreign aid pocket. We will provide you some concessional financing through our official export-credit facility, and our commercial banks will also lend a component part of the $1.2 billion total.

So what you have is a combination of official foreign aid and commercial credit. In a mixed credit project of that kind, $1.2 billion, which is not an unrealistic figure, the United States is at the very outset really frozen out because we don't have the resources nowadays as a nation, either through our foreign aid program or through our export credit program, to play in that kind of a game.

So we tend to get frozen out. Our response has been to ask our trading partners, primarily through the mechanism of the OECD, to agree to limits on the amounts and types of mixed credits that will be utilized. We have been rather successful in that, but not successful enough.

There is a meeting in April of this year of the Ministers of the OECD at which the United States again will press for the initiation of a further agreement to further limit mixed credits. It can be expected that the Japanese are going to use that device very, very much in gaining access to Eastern Europe, as are the Europeans.

And when you have a fertile field such as Eastern Europe opening for the first time, it is the company that gets in there first with the original equipment that tends to get the repeat sales. If, for example, you are going to buy a Caterpiller tractor, then you are going to tend to go with that product line rather than with Kamatsu, because of replacement parts and other considerations.

I was simply noting that the resources that the administration has, or that the United States has available, are extremely limited.

Mr. CARDIN. If our budget situation was different, do you believe that mixed credits are a fair way of competing in international business and new markets?

Mr. MCNEILL. No, I don't, sir. Because the way mixed credits are used by our trading partners is based on serving what they deem to be their national interest, which is exporting, and they will do whatever it takes to cut a deal to get the business.

We would prefer to see the business awarded on the basis of market considerations, and not government foreign aid or government political objectives.

So we think the mixed credit device is not a useful device.

Mr. CARDIN. Do you think the administration is moving aggressively enough in trying to restrict the use of mixed credits by our friends?

Mr. MCNEILL. They are moving aggressively. Whether or not they will be successful, I cannot give a qualitative answer to that. I do know it is an important agenda item for the administration. For the business community, it is a very critical problem.

Mr. CARDIN. It is still a major issue out there.

Mr. MCNEILL. Very, very major issue.

Mr. JENKINS. You know, Mr. Cardin, it is worth recalling that in the early seventies we, as an administration, started to negotiate with our allies to get rid of the subsidized international financing schemes, and some progress, as Bob has pointed out, has been made.

But the administration may or may not be aggressive enough in these negotiations. They are playing with a very weak hand. We have unilaterally abandoned this type of activity, so the others are enjoying the benefits of our nonpresence at the table. I think we would have more leverage if we had a stronger Eximbank and we could be out there, and it is like nuclear weapons, unilaterally disarming is not the way to get rid of nuclear weapons and I feel that that is the same in Eximbank financing.

Mr. CARDIN. Thank you, Mr. Chairman.

Mr. DOWNEY. Mr. Robinson, you have kind of an interesting approach to Jackson-Vanik. You are suggesting to us now that the—as I read Jackson-Vanik, the words aren't part of Jackson-Vanik, it is the deeds in Jackson-Vanik that make the difference and the deeds seem to speak pretty clearly. You suggested that, I think in your testimony, that you would favor a temporary waiver based on what, before the words, after the words, and then how long would the temporary waiver last, and how you would see the process of it being continued.

Mr. Robinson. First, I think a multiyear waiver, probably in the area of 2 years, would be an appropriate step if the President's own requirement is met of Soviet codification of an emigration law that ensures, as I stated earlier, emigration as a right, not a privilege of the Soviet people. I stand on that view as well as the White House's own statement, that some kind of implementation period is important.

It is not a matter of just seeing numbers of emigrants. We have already seen impressive numbers.

Mr. Downey. You would agree that that is all the law that Jackson-Vanik requires, this new codification is a new requirement that the President has added in.

Mr. Robinson. Yes. But I still think that it is a positive one from a human-rights perspective, because we do need to see protection under law in the U.S.S.R. as an additional safeguard to those seeking emigration.

Accordingly, I don't fault the President, even though it was not in the initial legislation, for this additional safeguard.

Mr. Downey. Of course, we have achieved the major change, have we not, when we would take the Soviets' word in terms of their legislation as having meant something, whereas before, of course, we were designing Jackson-Vanik, what they said in the law, what they said in their constitutions were nullities as far as we are concerned.

Mr. Robinson. Well, of course, that is an aspect of having a several-month period subsequent to Soviet legislation to ensure that those words do have meaning. We are not taking them at face value and I think that is appropriate.

Mr. Downey. Kempton, I was privileged to spend some time with Nikolay Shchmeliof recently, who is a free-market economist, if there is one in the Soviet Union, and he points out something that has not graced any of your combined testimony, about some of the stumbling blocks that the Soviets face in their attempt to achieve more open-market economy, and that is the attitude of the Soviet citizens themselves.

They have not been the beneficiaries of capitalism or Adam Smith for hundreds of years. Soviet Presidents were quite happy with the fact that if everyone around them was doing badly, they were content to do badly as well, and this recent revelation, that is both morally correct and economically advantageous, to be a self starter, to have individual initiative, is not met with favor among large numbers of their fellow citizens who look upon them as grasping capitalist parasites.

How long a period of time do you think it will be before the people in the Soviet Union appreciate the marketplace and the need for individual initiative and entrepreneurship, something that we can't do by extending credits or codifying laws or doing a number of things.

Mr. Jenkins. Well, you know, you are talking about historic change and historic periods tend to be longer than 6 months or 2 years. There is no tradition in the Soviet Union for a marketplace economy nor in czarist Russia either.

Someone on the panel said that there was no precedent for the kind of change which is occurring in Eastern Europe. That is not quite true. Chile has been through this. Under Allende, Chile was a nonmarket economy. The difference is that Chile had historically always been a market economy, and they were correcting a brief interlude.

Czechoslovakia historically has always been a part of the Western industrial world. Hungary has been closer to that. As you arrive in the Soviet Union, you get to the real tough problem.

I think it will take a long time. But that process will only start when the Soviet people begin to see consumer products become available to them.

You know, the East Germans have been witnessing this consumption, having West Germany represented for a long time on their television sets. The Soviets have not had that. They really don't fully know yet.

I think that it is a decade sort of a process, but it won't ever get there if we don't seize this opportunity and move in and start developing their consumption appetites.

Mr. **Downey**. I agree with that, and I also agree with the chairman. This is an appalling period in our history where historic change is viewed as a suspicion on the part of some, and as an opportunity to continue to squeeze the Soviets.

I hope we can get more what we want out of them in arms control and others, but I see a real opportunity here to expand trade and understanding that if we miss, the fault rests very squarely on our shoulders.

Mr. **Gibbons**. I would say to my friend from New York that you and I have never had a chance to go to the Soviet Union together, but when I go over there, I find they have got the most wonderful, flourishing black market. They got a bunch of entrepreneurs, but they just don't like to admit it. They will sell you anything that can be picked up and moved.

Mr. **Downey**. And also buy anything.

Mr. **Gibbons**. Yes. They know how to make a ruble for a buck or whatever currency you are doing business in.

Mr. **Jenkins**. I still don't recommend that you participate in that activity, Mr. Chairman.

Mr. **Gibbons**. I don't.

Mr. **Jenkins**. That sort of thing is pretty well isolated in the Moscow and Leningrad areas where the tourists appear regularly.

Mr. **Gibbons**. I don't know about the rest of the country, but I know from practical observation that you can't walk in those places without somebody trying to sell you a can of caviar. I don't know where the heck they got it from.

Mr. **Milosh**. Mr. Chairman, if I could add to that, there is a growing society of enterprises that is developing within the Soviet Union. These are small cooperatives that are flourishing now.

Unfortunately, there have been some setbacks in this sphere, but I think that what we will see is the private kind of enterprise flourishing to a greater extent in Hungary, in Poland, in Czechoslovakia, and that may be a symbol for the Soviets to go even faster in this direction.

Mr. **Robinson**. I would just chime in on Mr. Milosh's point and take the other side of Mr. Downey's earlier point. Is it a suspicion that the new Soviet 5-year plan represents a retreat to more bankrupt central planning and defers genuine systemic change as represented by decontrolling prices, permitting some forms of private ownership, and other kinds of privatization efforts?

The vilification of Soviet cooperatives is another disturbing point Gene mentioned, with inordinately high taxes, price controls, and new restrictions imposed after such cooperatives were assured of a level playing field on which to compete. So I don't think that it is merely our fault that we haven't adequately whetted consumer appetites in the Soviet Union; I think there could be more done in this area, but we have to remember that the Kremlin has a very potent share of the blame for not jump-starting United States-Soviet trade.

Mr. **Gibbons**. Let's go right down the list.

Mr. Levin.

Mr. **Levin**. Thank you, Mr. Chairman.

Mr. Jenkins, you talked about unilateral disarmament; you talked about Exim and its underutilization. Mr. McNeill mentioned that.

Mr. Robinson talked about subsidization and how we have failed to compete.

You said, Mr. Jenkins, there needs to be some kind of a blow torch.

Mr. Milosh says we call them, they don't call us for advice.

Tell me if you can, in an unvarnished way, what is going on. Why is it? Why has Exim been allowed by the administration to be not dismantled, but badly underfinanced?

I know there are lots of reasons for our lack of competitive strength in certain areas, but you were talking about one particular area. What is it all about? Why, under this administration, the previous administration, was Exim allowed to slide down?

Mr. **Jenkins**. You will recall your former colleague David Stockman was Director of OMB at the time when the new Reagan economic plan was being laid out, and among other things, he tried to address off-budget obligations as part of the budget concern.

Dick Darman is continuing that philosophical approach and it is realistic, I think, and it is probably healthy. But in this particular case, he targeted the Eximbank as being a subsidy and intervention by the state into the economic process, which is exactly what it is.

Mr. **Levin**. So you are saying that——

Mr. **Jenkins**. And I think it was ideological.

Mr. **Levin**. Ideological?

Mr. **Jenkins**. Right. And that struggle continues in our society today. I haven't seen a great rush of legislation being introduced to sharply increase the Eximbank's capabilities. With an exception of 2 or 3 years, the Eximbank is a profitmaker over history.

Mr. **Levin**. Some of us have tried to reverse the trend. You say it is ideological.

Mr. **Jenkins**. That is my impression.

Mr. **Levin**. That is mine too. Is it yours?

Mr. **McNeill**. Yes, sir, it is very much so mine.

The free marketeers at the time wanted to get the Government out of any kind of activity that involved any kind of alleged subsidy. The Export-Import Bank was deemed to be such an institution.

Mr. LEVIN. Mr. Milosh.

Mr. MILOSH. I would agree with that comment, and I do recall there was a major effort in getting our trading partners to equalize their export financing programs, but that was a total failure.

Mr. LEVIN. We have been talking about mixed credits for a decade and there is progress and you try to say, well, we are renegotiating, but it doesn't change much, does it? Well, you are all free marketeers.

What is going on here? You say the problem is that some want to get Government out of this, and you disagree with that.

Now, I mean, aren't you being inconsistent with the suggestions?

Mr. JENKINS. I don't think so. It is a question of how you get to that Nirvana of free marketplace, and my approach would be, and I think most of us in the business community feel this way, that if we have a strong Eximbank which is strongly funded, we are in a much better position at the negotiating table to persuade our allies and our economic adversaries to lower and limit the activities of finance subsidies.

Boeing can get in there and beat Air Bus with whatever kind of financing is necessary, and if the customer buys the airplane on the basis of quality, Boeing is going to win, and I think that kind of an experience is the way to bring other governments to the table successfully and start to ratchet down export financing subsidies.

Mr. LEVIN. Mr. Robinson.

Mr. ROBINSON. I am for meeting the competition and I agree with much of what has been said. The issue is one of selectivity as much as anything else.

I am a supporter of Eximbank even though they have been rather starved for funds. They did have a $4.8 billion loss reserve just established for loans and guarantees portfolios already outstanding.

I think that the Soviet Union, which is the topic of this morning, would be the wrong country at the wrong time for using these rather finite and precious U.S. Government funds and guarantees when we have some 40 developing countries which are in equally or more difficult economic straits and need this kind of support and where we can effectively compete with our trading partners.

So my comments should not be construed as negative to Eximbank per se. I am merely saying that the Soviet Union has not shown the commitment to genuine systemic reform that we are witnessing among a number of countries of Eastern Europe and which would make me more upbeat about considering restored access for the Soviet Union at this time.

Mr. LEVIN. Thank you.

Mr. GIBBONS. Mr. Moody.

Mr. MOODY. Just a brief comment regarding export subsidies, I don't want the record to indicate that we don't do it.

We do plenty of it in the agricultural area. I mean, it is a source of great irritation in Australia and Canada and other places that we do this to a rather high level and we have subsidized agricultural exports.

Let's not say that we are entirely pure here, because we are not at all. I leave it to you to comment on why we can do that in agricultural, but apparently not in other areas.

Any comments?

Mr. **Jenkins**. My only comment would be that as a result of our having agricultural engagement through the use of subsidies and other things, we have a principal role in shaping internal agricultural policy and practices today.

I think that Clayton Yeutter, who has announced his objectives in the GATT round, is in fact trying to use that leverage to get rid of this kind of activity, but he has seen the Europeans subsidizing their European assets now for certainly 5 years and certainly running our farmers out of business through Government policy, exporting their unemployment. And if you are going to be a player, you have to have a weapon. I think we can use that weapon.

I agree with what Roger said about the fact that the Soviet Union has not taken the reform steps that it must take. But once again, if we have leverage, we have the instrument, the carrot there in our hand, I think we are much more likely to have some effect on accelerating that reform process, which is central to the whole thing.

Mr. **Moody**. Mr. Robinson.

Mr. **Robinson**. On the other hand, this is an expensive policy tool for the American people—that is a war-chest of the type Mr. Jenkins is talking about, which would assist us in persuading our allies to get out of the subsidies business. I think that we have to have a more definite timetable for this kind of thing.

For example, we are as much as $1 billion or more deep in wheat subsidies to the Soviet Union since August 1986. We have to be careful or that will become $2 billion, remembering that we are in a period of ferocious budget austerity.

It seems to me that if we are going to get into the war-chest/subsidy approach as the U.S. club in the closet, we better negotiate with our allies on this subject more tenaciously than we are today and bring it to a conclusion. Otherwise, you are in an ad infinitum circumstance.

Mr. **Moody**. Well, the Europeans don't show much inclination for their own domestic political reasons to be ratcheted down, do they?

Mr. **Robinson**. We may have to consider new policy tools.

Mr. **Moody**. Would you agree with the statement made by another member of the committee here earlier, that GATT is totally useless? You are indicating that you think GATT is a helpful framework?

Mr. **Jenkins**. The best we have. It isn't perfect, but it is the best we have.

Mr. **Moody**. All of you agree with that?

Mr. **Milosh**. Absolutely. It is paramount in obtaining changes, such as in pricing controls, dumping, and trade law matters. We favor a stage approach to Soviet GATT membership.

Mr. **Moody**. There was discussion about whether the Soviet Union should get into GATT. Some say they would put little into it and get a lot out.

Mr. **Milosh**. They also have to give.

Mr. **Jenkins**. The U.S. Council has provided a statement on this outlining six or seven hurdles the Soviets would have to clear before they could become full observers and then beyond that additional steps they would have to take to become members.

Mr. Moody. Would they meet those hurdles?

Mr. Robinson. Yes, but that is a big if. Institutions, like the IMF and World Bank, are fundamentally incompatible with the continuation of a centrally controlled Soviet economy. So this is not a near-term prospect.

I would be more comfortable with U.S. policymaking that considers eligibility for the Baltic States which are further along in economic reform and where we could meaningfully differentiate parts of the Soviet Union from other parts. We could create a constructive competition among the republics of the U.S.S.R. and have these Baltic outposts, if you will, as a kind of free enterprise zone to help catalyze the kind of structural change in the Soviet Union that we have been looking for.

Mr. Moody. Wouldn't that require a change in currency? How can one member of GATT have more than one currency?

Mr. Robinson. This would be innovative policymaking. This deserves a serious look. It may be more achievable than we imagine.

Mr. Gibbons. I want to ask an administrative question. Would you members want to take an hour break and come back later or do you want to go on through?

Mr. Moody. I would like to take a break.

Mr. Cardin. Fine.

Mr. Gibbons. After this question, we will take a break for 1 hour. I had planned to go through but we have so many things going on in this place at one time it doesn't seem possible. The whole problem of export subsidy has worried me. I have not found a tool to get a grip on it yet. We all decry it. It is a violation of GATT in manufactured goods. Can we try something else other then negotiating? We don't seem to have any leverage.

Mr. Jenkins, you indicated the loaded gun. That is good but we can't seem to get the President to load it. Maybe we should do some unilateral loading, say, fellows we will give you a year to give up your export subsidies, we will cut out ours and you cut out yours.

If you have not done anything in a year, we will take some action in our market on your goods. The Germans and French would hear us, maybe the Japanese would hear us. What do you think of action like that?

Mr. McNeill. I would prefer to see the United States address that problem through fine tuning the subsidies code that was negotiated as part of the Tokyo round and try to get clearer agreement on the red, amber, and green light system where there could be better definition of those subsidies that are allowable, such as purely domestic subsidies for purely domestic purposes.

Mr. Gibbons. There is no doubt about tied aid. What the Japanese are doing in Hungary today, let's put it that way.

Mr. McNeill. I thought you were talking about the subsidies of the kind you addressed in your legislation some years ago.

Mr. Gibbons. No, I am talking about the export subsidies, tied aid particularly. It has been going on. We keep losing. Say "If you are going to subsidize in other markets, we are going to retaliate in our market to that extent."

Mr. McNEILL. We don't have the resources to carry through. We objected strongly to the tied-aid practices of the Japanese and Europeans.

We are still objecting and seeking agreements as to limits on those. We negotiated our own mixed credit facilities of $100 million in the Export-Import Bank, but that $100 million doesn't go very far. We are not in a position to be very credible in the utilization of such a threat. We don't have the resources at the end of that 1- or 2-year period to carry through.

Mr. GIBBONS. You are of the loaded gun philosophy school. I don't mind the loaded gun but I can't find anybody who wants to load it, particularly in the White House. Nobody wants to load it down there. They would all rather negotiate, I think.

Mr. ROBINSON. I would only say Mr. Gibbons that any hint of restricted access to the American marketplace is sure to get the attention of our allies. It won't necessarily be positive attention, but if we feel that the time has come when we have exhausted the "club in the closet" subsidies to match those of our trading partners toward the Soviet Union and we are in the process of open-ended subsidies at the expense of the American people, then we have to perhaps reexamine United States policy tools.

Although a different set of circumstances when we had problems enforcing the most sensible export controls on militarily relevant technology sales to the U.S.S.R. as we found in the Toshiba case that inflicted a multi-billion-dollar cost on American taxpayers, we took action with import controls as provided for in the Export Administration Act.

As a result, you saw an instantaneous domestic export control regime and bolstered participation in COCOM on the part of Japan. So although it is not a desirable step, if we should have the need for at least hinting at a more serious U.S. approach to this problem I think we will get the allies' attention immediately.

Mr. GIBBONS. Thank you all. I appreciate the quality and the time that you have devoted to this; not only this cause but all causes involving trade. We are going to take a 1-hour break now. At 1:30 we will reconvene here for the next part of the hearing.

AFTERNOON SESSION

Mr. GIBBONS [presiding]. Ladies and gentlemen, the time has arrived and I am going to start these hearings up.

This afternoon we are going to concentrate on the so-called Europe 1992 plan. As I have said often, I think Europe 1992 is the finest thing that has happened in Europe in the last 1,000 years and I hope it works out that way.

I hope that they continue successfully to the unification, and I also hope with equal vigor that they do not turn inward and do not exclude the rest of the world from participation in their market, and when I say the rest of the world, I am certainly including the United States.

I think it would be a terrible thing if in the unification process they excluded those of us who are very interested in and have been very helpful to them. I want to pay particular attention to the members of this panel.

This afternoon we are going to talk about not only some trade matters, but also the taxing matters that have to do with the Europe 1992. Our first group of witnesses are from the Xerox Corp., the Tax Council, and the Investment Company Institute.

From the Xerox Corp., Roland Magnin, who is the executive vice president, he is accompanied by Mr. Maletta. From the Tax Council, Mr. Lipner, accompanied by Mr. Lundy; and the Investment Company Institute, represented by David Silver.

Let's go first of all to Mr. Magnin, of the Xerox Corp.

Mr. Magnin.

STATEMENT OF ROLAND MAGNIN, EXECUTIVE VICE PRESIDENT, XEROX CORP., ACCOMPANIED BY THOMAS P. MALETTA, VICE PRESIDENT, TAXES

Mr. MAGNIN. I am executive vice president of the Xerox Corp. I am French. I am currently residing in the United States, and previously I was the head of Rank Xerox, which is a subsidiary of Xerox Corp., in Europe. Rank Xerox is a $4 billion company involving 30,000 people.

Accompanying me is Mr. Maletta, our vice president for taxes.

Mr. Chairman, and members of the Committee on Ways and Means, we are pleased to present testimony on behalf of Xerox Corp. pertaining to the implication of Europe 1992 on American direct investment in the European Community.

We believe that in order for U.S. industries to be competitive in today's economic environment, the U.S. tax and international trade laws must be reconciled with the new laws and economics of the EC single market.

We commend Chairman Rostenkowski and the committee on conducting these hearings and hope that we can provide some insight into some of the problems confronting U.S. multinational corporations as they attempt to develop more fully the EC single market.

Xerox markets its products in every State and over 130 countries. Its corporate headquarters are in Connecticut and its products are principally manufactured in New York, California, Oklahoma, and Texas.

It also operates major research and development facilities in New York and California.

Xerox maintains majority ownership, control, or management, either directly or indirectly, of virtually all of its approximately 120 subsidiaries. These subsidiaries perform sales, distribution, manufacturing, and service functions primarily in Europe, the Far East, Canada, Central and South America, and the Caribbean.

Xerox and its affiliates have made a significant investment of resources and capital in the EC member countries as a marketing vehicle for goods manufactured in the United States. In the existing environment, Xerox has had to deal with each of the 12 member countries of the EC individually.

A separate marketing corporation is currently maintained in each country. In addition, four separate manufacturing centers, including distribution outlets for manufactured and imported products, are operated within the EC. As a result, there has been considerable overlap of functions and inefficiencies.

Since the mid-1980's, Xerox has been attempting to rationalize its European corporate structure and business operations in response to the establishment of the single market. In the post-1992 single market, it is necessary for Xerox to consolidate its subsidiaries and eventually operate as a single EC corporation.

Thus, Xerox likely would incorporate under the new European company statute, which is expected to enable companies to incorporate under EC laws rather than under the law of a particular EC country. Operating costs will be reduced significantly by the advent of centralized functions such as warehousing, accounting, purchasing, cash and currency management, sales and services, and inventory management.

Centralized warehousing and distribution centers can be established reflecting the new EC economic structure and which are responsive to the geographic and regional operational requirements within the single market rather than the artificial political boundaries existing prior to EC-1992. Thus, Xerox will be able to more effectively compete in the EC market.

If Xerox does not move quickly to accomplish its planned restructuring in the EC, the company most likely will not be able to remain competitive with its principal competitors.

Japanese and European companies have already begun implementing similar streamlining plans in preparation for the single market.

It is imperative that Xerox and other U.S. multinationals respond now to the challenges presented by the creation of the single market. It is also important, however, that the U.S. Government respond equally quickly and effectively by removing barriers in the U.S. tax laws that do not permit U.S. businesses to compete on a level playing field in the new market.

Unnecessary obstacles to the restructuring of European subsidiaries by U.S. parent corporations should be eliminated. Essential revisions to the current tax laws must be made now, in advance of EC-1992, so that U.S. multinationals can timely react to the new rules, adjust their operations accordingly and be fully prepared to compete in the single market.

If the U.S. Congress waits until 1992 to begin serious deliberation of these issues, U.S. business will be unable to properly prepare for the new market and, as a result, will lag seriously behind its foreign-owned competition.

U.S. business needs a 2- to 3-year leadtime in order to restructure its manufacturing, marketing and distribution operations in order to successfully implement a balanced approach to EC-1992.

The definitions of foreign base company sale and services income in sections 954 (d) and (e) of the Internal Revenue Code of 1986, present two significant obstacles to the corporate restructuring necessitated by the creation of the unified market. In general, foreign base company sales and services income includes a European subsidiary's undistributed profits from certain transactions with related foreign entities.

Consequently, such income must be included as subpart F income on the U.S. tax returns of the U.S. parent corporation irrespective of whether the subsidiary actually distributes the income to the parent.

However, income earned by the subsidiary on similar transactions occurring within its country of incorporation are not included as such subpart F income. As a result, while European and Japanese industries are consolidating operations and increasing productivity in the EC, United States tax laws mandate U.S. businesses to establish or maintain subsidiaries in each European country to avoid subpart F treatment of income from these countries.

Unfortunately, these separate subsidiaries increase operating costs, as explained earlier, thereby making United States multinationals less competitive.

To allow United States industries a full opportunity in the unified European market, the U.S. tax laws should be amended so that EC countries are treated as a single country for purposes of determining whether the income of a U.S. multinational's controlled foreign corporation is sales or services income taxable under subpart F.

Such a change would harmonize the subpart F rules with the European company statute and provide United States multinationals an opportunity to compete fairly with foreign competitors.

Generally, a U.S. corporation is not taxed on the earnings of its foreign subsidiaries until those earnings are distributed to the U.S.-parent corporation. However, the Tax Code establishes an exception to that general rule by requiring the U.S.-parent corporations of foreign subsidiaries to include in gross income their share of subpart F income earned by the foreign subsidiary even though the income has not been distributed to the parent corporation.

Subpart F income includes various types of income which Congress has determined should be ineligible for the general rule of deferral of U.S. tax on the parent corporation until the income is actually repatriated.

In general, foreign base company sales income includes income earned by a foreign subsidiary in a transaction in which, first, a purchase or sale is made with a related party; second, involving a product manufactured outside the subsidiary's country of incorporation; and third, the product is sold for use outside the subsidiary's country of incorporation.

Under these rules, income earned by our U.K. subsidiary on the purchase of a product manufactured in our Webster, NY, plant and sold by the U.K. company to a related company in France would be this tainted subpart F income and the income on the transaction would be taxable in the United States even though the income is not distributed to Xerox Corp.

However, if the U.K. company sold the same product to one of its U.K.- affiliated companies, the income from the transaction would not be taxable as subpart F income in the United States.

Therefore, by establishing separate subsidiaries in each EC country in which it does business, rather than one consolidated subsidiary, a U.S. multinational can defer the tax on income received from similar transactions. However, it incurs duplicative selling, technical, general and administrative expenses.

Section 954(b)(4) of the Internal Revenue Code of 1954 provided an exception to the subpart F rules. Under this old exception, a

U.S.-parent corporation was not required to include under subpart F the income earned by its foreign subsidiary if it could demonstrate that the avoidance of U.S. tax was not significant reason for the creation of the foreign subsidiary or for the completion of the transaction giving rise to the income.

The Tax Reform Act of 1986 eliminated the subjective nature of this exception and the Tax Code now only provides an exception in a case where the foreign base company income has been subject to an effective rate of foreign tax greater than 90 percent of the maximum U.S. corporate tax rate.

Although the maximum statutory tax rates in virtually all EC countries are higher than the current maximum U.S. corporate, it is very difficult for a U.S. multinational to predict with any degree of certainty whether it will qualify for this exception from year to year.

Due to the resulting unpredictability as to whether income will be taxable as subpart F income or qualify for the exception, many U.S. multinationals have opted for establishing separate subsidiaries in each of the 12 EC countries in order to ensure avoiding subpart F treatment of its foreign base company income.

The subpart F rules were enacted nearly 30 years ago to address Congress' concern regarding the creation of foreign base companies in tax haven jurisdictions. The primary basis for the new rules was the loss of tax revenue from the artificial shifting of income by U.S. corporations to foreign subsidiaries created in tax haven jurisdictions merely to obtain lower tax rates.

However, Congress did not intend to impair the competitive position of foreign subsidiaries established for legitimate income producing activities.

The definition of foreign base company sales and services income provides U.S. multinationals with a paradoxical incentive to maintain duplicative subsidiaries in each EC country. Thus, U.S. corporations are confronted with the choice between maintaining inefficient corporate structures or losing U.S. tax deferral on their EC-source income.

In contrast, European and Japanese companies against which U.S. multinationals compete are able to make sound business decisions and reshape their corporate structures to respond to the new single market without such an artificial tax incentive to develop or continue costly operations in each EC country.

To allow U.S. multinationals a fair opportunity to contend with their foreign competitors and to make sound business decisions regarding the streamlining of activities in the EC, subpart F should be amended to treat the EC as one country for purposes of computing foreign base company sales income.

This would allow U.S. multinationals to create more efficient European corporate subsidiary structures without risking the loss of the tax deferral on income that has not been repatriated.

Consequently, it would enhance their competitive position in the European market and provide them with the same structural options as their European and Japanese competitors currently enjoy.

To maximize the new opportunities presented by the creation of the new EC single market, U.S. multinationals must be able to consolidate operations and eliminate inefficiencies.

The U.S. tax laws must be modified now to provide those U.S. corporations a timely opportunity to successful compete with their foreign-owned competitors.

Amending the subpart F rules to allow the EC to be treated as a single country for purposes of determining subpart F income is consistent with the development of the single market and the European company statute.

It is also consistent with the original policy goals that led to the enactment of the rules, which were to deter the use of base companies in tax havens while preserving the policy of deferring U.S. taxation of income earned by foreign subsidiaries created for legitimate business reasons.

Finally, it will allow U.S. businesses to develop and expand their roles in the EC single market.

[The statement of Mr. Magnin follows:]

STATEMENT OF ROLAND MAGNIN
EXECUTIVE VICE PRESIDENT, XEROX CORPORATION

Mr. Chairman and members of the Committee on Ways and Means, I am pleased to present testimony on behalf of Xerox Corporation pertaining to the implications of "Europe 1992" on American direct investment in the European Community ("EC"). We believe that in order for U.S. industries to be competitive in today's economic environment, the U.S. tax and international trade laws must be reconciled with the new laws and economics of the EC Single Market in order to allow U.S. businesses a full and fair opportunity to compete effectively in the EC. We commend Chairman Rostenkowski and the Committee on conducting these hearings and hope that we can provide some insight into some of the problems confronting U.S. multinational corporations as they attempt to develop more fully the EC Single Market.

Xerox Corporation ("Xerox") markets its products in every state and over 130 countries. Its corporate headquarters are in Connecticut and its products are principally manufactured in New York, California, Oklahoma and Texas. It also operates major research and development facilities in New York and California.

Xerox is comprised of several major operating divisions. The largest segment, the Business Products and Systems Division, has responsibility for Xerox's traditional office automation products including copiers, duplicators, electronic printers, electronic typewriters, workstations, software and related servicing and suppliers.

Xerox maintains majority ownership, control, or management, either directly or indirectly, of virtually all of its approximately 120 subsidiaries. These subsidiaries perform sales, distribution, manufacturing and service functions primarily in Europe, the Far East, Canada, Central and South America and the Caribbean. Xerox's operations in these countries are essential to the absorption of base costs, including research and development investments, incurred in the United States and to reducing its unit cost of production, thereby better enabling its products to be competitive in both the United States and foreign markets.

The 1980s was a decade in which the United States experienced unprecedented trade deficits. However, the creation of the EC Single Market by the end of 1992 presents Xerox and other U.S. multinational corporations with a unique opportunity to develop and expand their markets in the twelve member countries of the EC. The unified EC also will provide a springboard to capitalize on the emerging markets in Eastern Europe.

Xerox and its affiliates have made a significant investment of resources and capital in the EC member countries as a marketing vehicle for goods manufactured in the United States. In the existing environment, Xerox had to deal with each of the twelve member countries of the EC individually. A separate marketing corporation is currently maintained in each country. In addition, four separate manufacturing centers, including distribution outlets for manufactured and imported products, are operated within the EC. As a result, there had been considerable overlap of functions and inefficiencies.

Since the mid-1980s, Xerox has been attempting to "rationalize" its European corporate structure and business operations in response to the establishment of the Single Market. In the post-1992 Single Market, it is necessary for Xerox to consolidate its twelve distinct marketing subsidiaries as well as its four separate manufacturing and distribution subsidiaries and eventually operate as a single EC corporation. Thus, Xerox likely would incorporate under the new European Company Statute, which is expected to enable companies to incorporate under EC laws rather than under the law of a particular EC country. Operating costs will be reduced significantly by the advent of centralized functions such as warehousing, accounting, purchasing, cash and currency management, sales and services and inventory management. Centralized warehousing and distribution centers can be established reflecting the new EC economic structure and which are responsive to the geographic and regional operational requirements within the Single Market rather than the artificial political boundaries existing prior to EC 1992. Thus, Xerox will be able to more effectively compete in the EC market.

If Xerox does not move quickly to accomplish its planned restructuring in the EC, the company most likely will not be able to remain competitive with its principal competitors. Japanese and European companies have already begun implementing similar streamlining plans in preparation for the Single Market.

It is imperative that Xerox and other U.S. multinationals respond now to the challenges presented by the creation of the Single Market. It is also important, however, that the U.S. government respond equally quickly and effectively by removing barriers in the U.S. tax laws that do not permit U.S. businesses to compete on a level playing field in the new market. Unnecessary obstacles to the restructuring of European subsidiaries by U.S. parent corporations should be eliminated. Essential revisions to the current tax laws must be made now, in advance of EC 1992, so that U.S. multinationals can timely react to the new rules, adjust their operations accordingly and be fully prepared to compete in the Single Market. If the U.S. Congress waits until 1992 to begin serious deliberation of these issues, U.S. business will be unable to properly prepare for the new market and, as a result, will lag seriously behind its foreign-owned competition. U.S. business needs a two to three year lead time in order to restructure its manufacturing, marketing and distribution of its products in order to successfully implement a balanced approach to EC 1992.

The definitions of foreign base company sales and services income in sections 954(d) and (e) of the Internal Revenue Code of 1986 present two significant obstacles to the corporate restructuring necessitated by the creation of the unified market. In general, foreign base company sales and services income includes a European subsidiary's undistributed profits from certain transactions with related foreign entities. Consequently, such income must be included as "subpart F income" on the U.S. tax returns of the U.S. parent corporation irrespective of whether the subsidiary actually distributes the income to the parent. However, income earned by the subsidiary on similar transactions occurring within its country of incorporation are not included as such subpart F income. As a result, while European and Japanese industries are consolidating operations and increasing productivity in the EC, U.S. tax laws mandate U.S. businesses to establish or maintain subsidiaries in each European country to avoid subpart F treatment of income from these countries. Unfortunately, these separate subsidiaries increase operating costs, as explained earlier, thereby making U.S. multinationals less competitive.

To allow U.S. industries a full opportunity in the unified European market, the U.S. tax laws should be amended so that EC countries are treated as a single country for purposes of determining whether the income of a U.S. multinational's controlled foreign corporation is sales or services income taxable under subpart F. Such a change would harmonize the subpart F rules with the European Company Statute and provide U.S. multinationals an opportunity to compete fairly with foreign competitors.

Current Law Treatment of Subpart F Income

Generally, a U.S. corporation is not taxed on the earnings of its foreign subsidiaries until those earnings are distributed to the U.S. parent corporation. However, the tax code establishes an exception to that general rule by requiring the U.S. parent corporations of foreign subsidiaries to include in gross income their share of subpart F income earned by the foreign subsidiary even though the income has not been distributed to the parent corporation.

Subpart F income includes various types of income which Congress has determined should be ineligible for the general rule of deferral of U.S. tax on the parent corporation until the income is actually repatriated. In general, foreign base company sales income includes income earned by a foreign subsidiary in a transaction in which (i) a purchase or sale is made with a related party, (ii) involving a product manufactured outside the subsidiary's country of incorporation, and (iii) the product is sold for use outside the subsidiary's country of incorporation. Under these rules, income earned by our U.K. subsidiary on the purchase of a product manufactured in our Webster, New York, plant and sold by the U.K. company to a related company in France would be this tainted subpart F income and the income on the transaction would be taxable in the United States even though the income is not distributed to Xerox corporation. However, if the U.K. company sold the same product to one of its U.K. affiliated companies, the income from the transaction would not be taxable as subpart F income in the United States. Therefore, by establishing separate subsidiaries in each EC country in which it does business, rather than one consolidated subsidiary, a U.S. multinational can defer the tax on income received from similar transactions. However, it incurs duplicative selling, technical, general and administrative expenses.

Section 954(b)(4) of the Internal Revenue Code of 1954 provided an exception to the subpart F rules. Under this "old" exception, a U.S. parent corporation was not required to include under subpart F the income earned by its foreign subsidiary if it could demonstrate that the avoidance of U.S. tax was not a significant reason for the creation of the foreign subsidiary or for the completion of the transaction giving rise to the income. The Tax Reform Act of 1986 eliminated the subjective nature of this exception and the tax code now only provides an exception in cases where the foreign base company income has been subject to an effective rate of foreign tax greater than 90 percent of the maximum U.S. corporate tax rate. Although the maximum statutory tax rates in virtually all EC countries are higher than the current maximum U.S. corporate rate, it is very difficult for a U.S. multinational to predict with any degree of certainty whether it will qualify for this exception from year-to-year. The differences between the tax rules and accounting methods applicable in foreign countries and the special rules applicable for purposes of calculating the effective foreign tax rate for subpart F purposes often can result in a foreign subsidiary not qualifying for the section 954(b)(4) exception in any given year. Due to the resulting unpredictability as to whether income will be taxable as subpart F income or qualify for the exception, many U.S. multinationals have opted for establishing separate subsidiaries in each of the twelve EC countries in order to ensure avoiding subpart F treatment of its foreign base company income.

The subpart F rules were enacted nearly thirty years ago to address Congress' concern regarding the creation of foreign base companies in tax haven jurisdictions. The primary basis for the new rules was the loss of tax revenue from the artificial shifting of income by U.S. corporations to foreign subsidiaries created in tax haven jurisdictions merely to obtain lower tax rates. However, Congress did not intend to impair the competitive position of foreign subsidiaries established for legitimate income producing activities.

Effect of Subpart F on U.S. Competitiveness in the Single Market

The definition of foreign base company sales and services income provides U.S. multinationals with a paradoxical incentive to maintain duplicative subsidiaries in each EC country. Thus, U.S. corporations are confronted with the choice between maintaining inefficient corporate structures in the EC or losing U.S. tax deferral on their EC-source income. In contrast, European and Japanese companies against which U.S. multinationals compete are able to make sound business decisions and reshape their corporate structures to respond to the new Single Market without such an artificial tax incentive to develop or continue costly operations in each EC country.

If U.S. multinationals maintain separate subsidiaries in each member country of the EC to avoid subpart F treatment of income, they will not benefit to the same extent as their foreign competitors from the creation of the Single Market. The impact of the treatment of subpart F income for U.S. multinationals operating in the EC can best be described by analogy to the United States. If similar subpart F rules were in effect in the United States, each U.S. corporation would be encouraged to establish a self-contained subsidiary in each state and would have to file and maintain the appropriate records and documents required by the individual states. Each subsidiary would be constrained from selling products for consumption or use outside of its state of incorporation. In addition, parent companies would lose a substantial portion of the cost efficiencies associated with centralized management and operations. Under this analogy, U.S. companies would be governed by these rules while foreign companies could operate far more efficiently as a single corporation throughout the United States. These foreign corporations would have such significant advantages over their U.S. counterparts that it would be virtually impossible for the U.S. businesses to survive. Similarly, U.S. multinationals are at a disadvantage in the EC since they are effectively denied the same advantages available to their foreign competitors as a result of the development of EC 1992.

The definitions of foreign base company sales and services income were developed nearly 30 years ago on the basis that each European country should be treated as a distinct market and that a company's country of incorporation was its natural business location. The primary purpose and goals of EC 1992 are contrary to the rationale for the definition of foreign base company income and, as a result, the definitions are outdated and counterproductive. In addition, the definitions will conflict with the European Company Statute. If a U.S. corporation incorporates under this statute, it will be uncertain as to which EC country will be deemed its country of incorporation for purposes of determining subpart F income. Although the Internal Revenue Code would be unclear, the company could justly argue that for these purposes its country of incorporation is the entire EC. Consequently, without Congressional action, it will be unclear as to how the current subpart F rules should be administered in the context of EC 1992.

Treatment of the EC as a Single Country for Subpart F Purposes

To allow U.S. multinationals a fair opportunity to contend with their foreign competitors and to make sound business decisions regarding the streamlining of activities in the EC, subpart F should be amended to treat the EC as one country for purposes of computing foreign base company sales or services income. This would allow U.S. multinationals to create more efficient European corporate subsidiary structures without risking the loss of the tax deferral on income that has not been repatriated. Consequently, it would enhance their competitive position in the European market and provide them with the same structural options as their European and Japanese competitors currently enjoy.

To discourage U.S. companies from establishing subsidiaries in tax haven countries, the amendment could limit the applicability of the single EC country standard to jurisdictions that have a maximum corporate rate greater than 90 percent of the highest U.S. corporate rate and do not provide a tax holiday, or other similar special rules, for foreign base company income. By thus limiting the scope of this EC amendment to the subpart F rules, the U.S. multinationals that operate legitimate subsidiaries in the EC would not lose the tax deferral of income but tax shelter enterprises would not be able to establish subsidiaries in tax haven countries solely for the purpose of tax avoidance.

Due to the application of the current foreign base company sales and services income rules, U.S. companies have retained the income deferral by establishing otherwise unnecessary subsidiaries in each EC country. Consequently, the current rules have resulted in a relatively minor source of U.S. tax revenues. Since many U.S. companies will continue to maintain separate subsidiaries in each EC country if the subpart F rules are not modified, and thereby continue to receive the income deferral, an amendment treating the EC as a single country would cause only minimal reduction in U.S. tax revenues. However, this amendment would allow U.S. multinationals to make the business decisions regarding their EC subsidiaries that are essential to remain competitive in the Single Market.

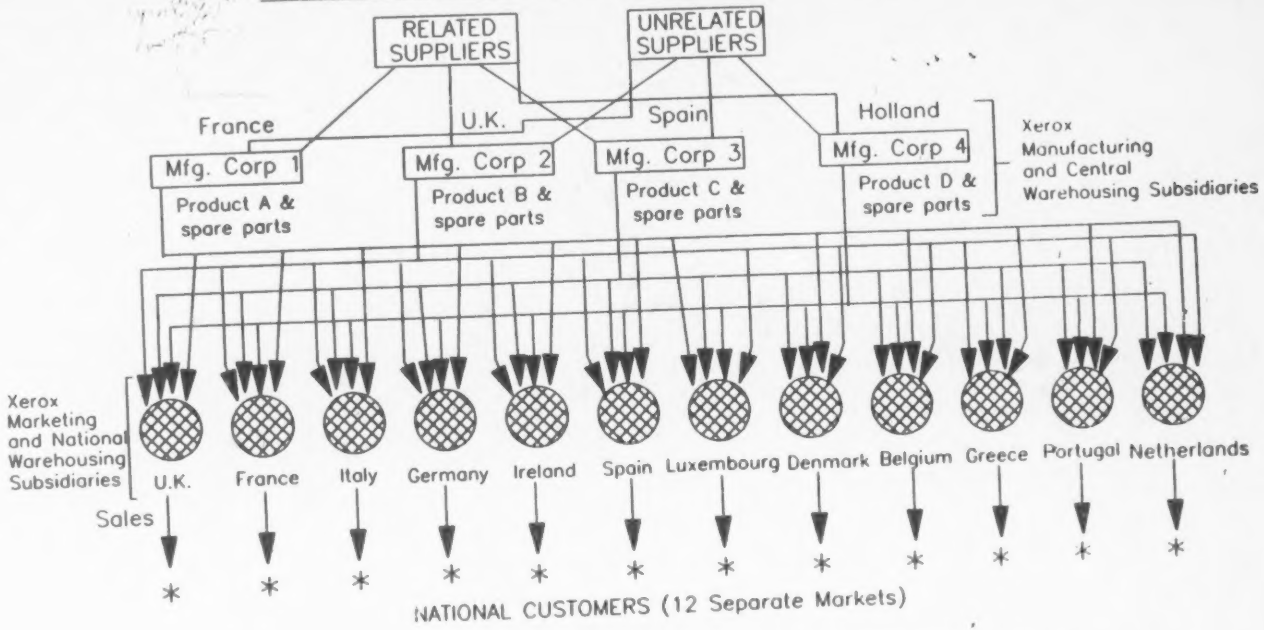
Summary

To maximize the new opportunities presented by the creation of the new EC Single Market, U.S. multinationals must be able to consolidate operations and eliminate inefficiencies. The U.S. tax laws must be modified now where appropriate to provide those U.S. corporations a timely opportunity to successfully compete with their foreign-owned competitors. European and Japanese companies will be able to make the necessary corporate structural changes allowing them to operate more efficiently in the single market.

The current definitions of foreign base company sales and services income present an unnecessary obstacle to U.S. corporate planning and management in the EC. Amending the subpart F rules to allow the EC to be treated as a single country for purposes of determining subpart F income is consistent with the development of the Single Market and the European Company Statute. It is also consistent with the original policy goals that led to the enactment of the rules, which were to deter the use of base companies in tax havens while preserving the policy of deferring U.S. taxation of income earned by foreign subsidiaries created for legitimate business reasons. Finally, it will allow U.S. businesses to develop and expand their roles in the EC Single Market.

CHART I

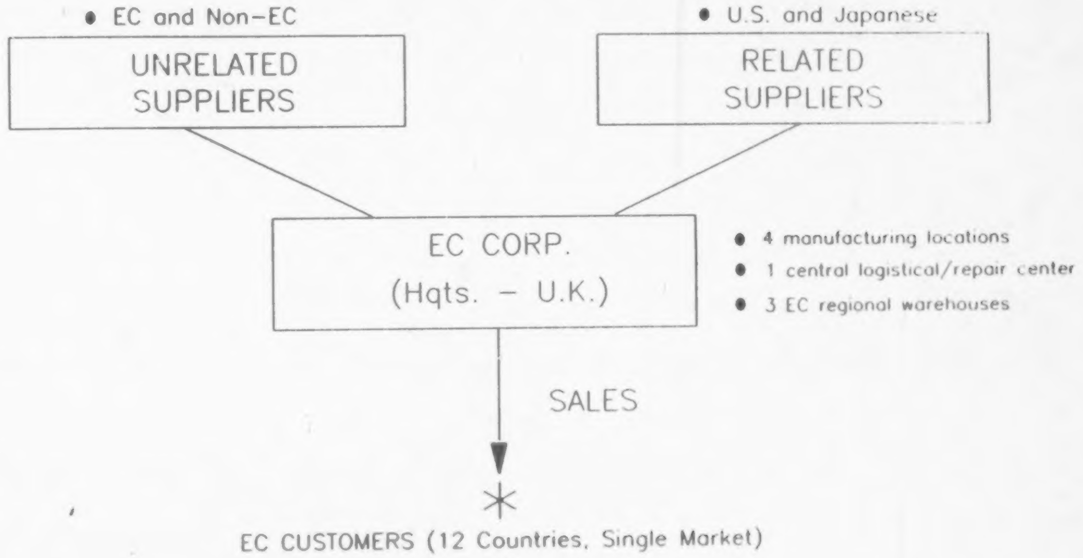
MID-1980s EUROPEAN STRUCTURE


RELATED SUPPLIERS
UNRELATED SUPPLIERS
France
U.K.
Spain
Holland
Mfg. Corp 1
Product A & spare parts
Mfg. Corp 2
Product B & spare parts
Mfg. Corp 3
Product C & spare parts
Mfg. Corp 4
Product D & spare parts
Xerox Manufacturing and Central Warehousing Subsidiaries
Xerox Marketing and National Warehousing Subsidiaries
U.K.
France
Italy
Germany
Ireland
Spain
Luxembourg
Denmark
Belgium
Greece
Portugal
Netherlands
Sales
*
NATIONAL CUSTOMERS (12 Separate Markets)

- Each of four manufacturing subsidiaries acquires raw materials and spare parts directly from suppliers within and outside Europe and warehouses finished goods and spare parts to satisfy 12 EC marketing corporations.
- Each of four manufacturing subsidiaries sells its particular products and spare parts to 12 separate marketing companies with national warehousing facilities.
- Sales and services income was not subpart F income prior to TRA 1986 due to the "not found or availed of" test in section 954(b)(4).

CHART II

POST-1992 TARGET EUROPEAN STRUCTURE


• EC and Non-EC
UNRELATED SUPPLIERS
• U.S. and Japanese
RELATED SUPPLIERS
EC CORP.
(Hqts. – U.K.)
• 4 manufacturing locations
• 1 central logistical/repair center
• 3 EC regional warehouses
SALES
EC CUSTOMERS (12 Countries, Single Market)

- Single EC subsidiary has manufacturing, warehousing, marketing and servicing functions throughout 12 EC countries
- Economies of scale generated by centralization of such functions as purchasing invoicing, currency risk and cash management, accounting, debt financing, warehousing, and inventory management
- Foreign base company sales income from spare parts and machines purchased from related U.S. and Japanese suppliers is taxed to Xerox Corp. unless actual foreign taxes paid exceed 90 percent of maximum U.S. corporate tax rate (34% x 90% = 30.6%). Annual fluctuations, such as foreign NOL carryforwards and timing differences, prevent reliance on the "high-tax" exception
- Foreign base company sales income of the U.K. corporation is also generated through sales of machines produced at non-U.K. manufacturing locations

Mr. GIBBONS. Thank you, Mr. Magnin.

Next we will go to Mr. Lipner.

STATEMENT OF ALAN J. LIPNER, CHAIRMAN, TAX POLICY COMMITTEE, THE TAX COUNCIL, AND SENIOR VICE PRESIDENT-TAXES, AMERICAN EXPRESS CO., ACCOMPANIED BY DANIEL F. LUNDY, MEMBER, BOARD OF DIRECTORS, THE TAX COUNCIL, AND SENIOR VICE PRESIDENT AND DIRECTOR OF TAXES, ITT CORP.

Mr. LIPNER. Thank you, Mr. Chairman, for the opportunity to appear here and speak before you.

My name is Alan J. Lipner. I am chairman of the policy committee of the Tax Council, and I am also senior vice president of taxes at American Express.

I am joined here by Mr. Lundy, who is senior vice president of taxes at the ITT Corp. First of all, Mr. Chairman, let me say that the Tax Council supports your committee's efforts to explore and address the implications for United States business of Europe 1992 and in an open Eastern Europe.

The Tax Council applauds this committee's efforts to ensure equitable trade laws, and that has meant very, very much to our members. But I would now like to call your attention, Mr. Chairman, to the U.S. tax laws which put U.S. corporations at a severe competitive disadvantage with European, Japanese, and other multinational corporations.

Xerox, in their submission, mentioned the fact that the European Economic Community should be treated from a U.S. tax standpoint as one country, and we agree with that.

In fact, in our detailed submission, we have referred to that. And by the way, though we'd like the detailed submission to be entered into the record, I am going to basically talk extemporaneously rather than read from that.

Mr. GIBBONS. Without objection, your entire statement will be made a part of the record.

Mr. LIPNER. Thank you very much.

There are very serious problems with our tax laws that puts us at a competitive disadvantage, as I said, with other multinational companies, and let me mention a few of them. One is the affiliated group method of allocating expenses and in particular, interest, in calculating foreign source income. That results often in U.S. companies paying extra taxes because of the way the foreign tax credit calculation is done. In effect, you could pay maybe 70-percent tax, U.S. and foreign tax, on foreign income.

A very severe disadvantage is the separate company-by-company limitation on 10/50 joint ventures. It basically hurts U.S. companies trying to go outside the United States in the form of joint ventures where you own less than 50 percent. It puts us at a very severe disadvantage, and could make a profitable transaction into an unprofitable transaction.

The high withholding tax basket that was created in the foreign tax credit rules basically puts the banks at a severe disadvantage when competing with other foreign banks. There are other issues that we deal with: the overall domestic losses, the repeal of the Bon Ami rule, all very technical rules and I don't want to go into them.

Your staff is quite aware of these rules, but something has to be done to ameliorate these rules. The limitation of foreign tax credits in the alternative minimum tax to 90 percent puts us at a disadvantage, because it creates double taxation.

The repeal of deferral for active banking, insurance and finance companies outside the United States puts us, U.S. companies, at a very competitive disadvantage. And in the last 12 months, two U.S. companies have sold off controlling interests of European banks. I would venture to say that this will continue.

The extraterritorial provisions of the U.S. tax law as it applies to the life insurance industry is another example. Our company looked at a foreign acquisition, a foreign life insurance company, which we were hoping would be our entry to Europe 1992, in selling life insurance. When we finished analyzing the acquisition, we concluded that the U.S. tax on the economic earnings of that company would equal 300 percent of the company's economic earnings. I think that is a problem with the tax law that has to be resolved. These are just a few examples of what we have dealt with in our paper of the problems that exist with the U.S. tax law. And I urge your committee to consider these problems which are very important for U.S. companies abroad. Thank you.

[The statement of Mr. Lipner follows:]

Statement of The Tax Council
on
Tax Strategy and Europe 1992
Submitted to the
Committee on Ways and Means
U.S. House of Representatives
January 30, 1990

Mr. Chairman and Members of the Committee, I am Alan Lipner, Senior Vice President-Taxes of the American Express Company and Chairman of The Tax Council's Tax Policy Committee, and I am accompanied by Mr. Dan Lundy, Senior Vice President and Director of Taxes of the ITT Corporation. We are testifying on behalf of the Tax Council.

The Tax Council was established in 1967 to provide a forum for the evaluation of Federal tax policy. Consisting of approximately 100 members, the Tax Council represents a wide cross-section of the business community including manufacturing, mining, energy, electronics, transportation, public utilities, consumer products, retailing, public accounting, and financial services. Participating individuals typically are the top tax and financial executives of their companies. It is these individuals who have the responsibility of attempting to explain to senior management the impact of U.S. tax rules on the foreign operations of their companies. On behalf of the Tax Council, I welcome the opportunity to present the following comments on the role that U.S. tax laws will play on the competitive position of U.S. companies in the emerging market places of the European Community and Eastern Europe.

The last decade has witnessed explosive changes in this nation's trade and foreign tax laws. In 1984, the Ways and Means Committee ensured passage of critical legislation recognizing the importance of services in our international trade policies. Less than two years ago this Committee completed its work on the 1988 Omnibus Trade Bill. That historic legislation represented an extraordinary effort by the Congress to develop a strong and comprehensive framework for U.S. trade policy. The bill challenged our trading partners to undertake a real commitment to promote growth in world trade through multilateral and bilateral negotiations. Most importantly, the bill demonstrated that international competitiveness is a top priority for the United States.

Paradoxically, during this same time frame, the U.S. tax system has become more proscriptive, frustrating the ability of U.S. companies to compete against their foreign competitors in international markets. It is our hope that, as this Committee moves forward to review and refine the U.S. policy with regard to Europe 1992 and Eastern Europe, you will merge foreign trade and tax policies into a coherent system that will foster the competitive position of U.S. companies in these markets.

While a wholesale overhaul of the U.S. system of taxing its multinationals may not be feasible, efforts can be made to restore and, indeed, improve U.S. competitiveness abroad. U.S. tax laws should facilitate, and not impede, the success of U.S. overseas investment and trade. With that premise in mind and reflecting the diverse membership of The Tax Council, we would like to address several specific areas of present law which should be changed.

Our recommendations address those provisions of current law that may directly impair access to and needed flexibility in European markets, as well as those U.S. tax rules that in their application impose such signficantly higher tax costs on the foreign operations of U.S. companies that they potentially price U.S. businesses out of these marketplaces. We have also commented on several technical deficiencies in the present system which impose inequitable burdens on U.S. taxpayers. It should be noted that many of our recommendations are generic in character, and upon enactment, would enhance the international competitiveness of U.S. companies both in Europe and in the remainder of the world.

With regard to these recommendations, The Tax Council makes no pretense as to presenting a revenue-neutral package. Some of our proposals are technical and would have very little, if any, impact. Others would have more significant revenue implications, at least on a static basis. Our guide is what we see as sound tax policy to meet global competition.

THE FOREIGN TAX CREDIT

1. Separate limitation for noncontrolled Sec. 902 corporations

The separate company-by-company limitation for each non-controlled Sec. 902 corporation (a so-called "10/50 company") should be eliminated and replaced by the general "look through" scheme. 10/50 companies are typically part of the integrated business of the U.S. shareholder. No sound policy is served by isolating the foreign tax credits of an integrated business into hundreds or thousands of discrete baskets.

U.S. companies frequently establish 10/50 companies to facilitate access to foreign markets. Local expertise, the price of which is majority foreign ownership, is often needed to succeed in the market. The need for such joint ventures will be especially true as U.S. companies seek access to Eastern European marketplaces, where unions between Western management expertise and Eastern European manufacturing facilities are being forged. These joint ventures will serve as the prototype for U.S. entry into these markets.

Penalizing U.S. taxpayers for their exercise of sound business judgement, and perhaps precluding the only viable means of competing in certain foreign markets, is bad trade and bad tax policy --- foregone revenues do not generate U.S. tax dollars. Further, a number of foreign countries restrict the extent to which foreign persons may invest in local enterprises. That adverse U.S. tax consequences, born of no compelling policy concern, should foreclose U.S. entry into these countries is plainly untenable.

In enacting the 10/50 company limitation, Congress expressed an administrative concern with respect to a U.S. shareholder's ability to obtain information permitting an analysis of 10/50 company earnings under the look-through rules. This concern appears to be unwarranted: a 10% U.S. shareholder will and, in fact, must have access to foreign company earnings data to calculate and support its indirect foreign tax credit. If the 10/50 company limitation is not repealed in its entirety, an election out of the limitation should be made available for U.S. shareholders possessing the necessary data.

Incident to this change, it should be provided that gains on the sale of stock of any Sec. 902 corporation should be included in the same separate limitation and accorded the same source as would dividends from such corporation.

2. Affiliated group allocation of interest and other expenses

Article 58 of the Treaty of Rome entitles all firms (independent of parent company residence) organized under the laws of an EC member state to be treated as European firms. Thus, it is intended that EC subsidiaries of U.S. companies will be subject to fiscal policies no less advantageous than those applicable to European-owned firms.

To reflect this spirit, the allocation of interest (and other expenses) among related U.S. corporations should be controlled by the internationally recognized principles of Sec. 482, and not by the present affiliated group rules. The expense so allocated to each U.S. corporation should then be fairly allocated or apportioned against its foreign income.

The affiliated group allocation rules distort the computation of the foreign tax credit limitation, raising the incidence of double taxation and the competitive disadvantage for U.S. businesses operating abroad. Distortion occurs because expenses incurred to fund and support purely domestic activities of a U.S. corporation are allocated to foreign source income generated by other domestic and foreign entities, whose only connection with the U.S. corporation and its expenses is the fact of affiliation.

Distortion is also caused by the inclusion of foreign subsidiary stock in the affiliated group asset base to which interest expense is allocated, but the failure to take into account foreign subsidiary interest expense incurred on external borrowings. Assume, for example, a U.S. parent company, engaged only in domestic business, and its wholly owned foreign subsidiary, each of which borrows externally to fund its own operations. Under the affiliated group rules, the U.S. parent company's interest expense is allocated to the parent company's foreign asset (the subsidiary stock), without an offset for the interest expense incurred directly by the subsidiary, and foreign interest expense is effectively double counted. The double counting understates the foreign source income attributable to the foreign subsidiary, causing double taxation of the foreign subsidiary's earnings and a clear competitve disadvantage to the U.S. parent multinational.

The inequity and anti-competitive consequences of the affiliated group allocation rules, as well as the administrative complexity and dedication of compliance resources which they entail, far outweigh their intended purpose and warrant their repeal or at least major modification.

3. Separate limitation for high withholding tax interest

The separate limitation for high withholding tax interest should be repealed or substantially modified. The isolation of foreign taxes in the passive and financial services categories of foreign source income is sufficient protection from abusive tax-motivated investment. Moreover, by impairing the economics of cross-border lending, the separate limitation for high withholding tax interest provides foreign-controlled lenders with a significant, tax-based competitive advantage over U.S. companies. Given new opportunities to assist in the financing of a rapidly developing European economy, U.S. overseas lending, especially the financing of U.S. exports, should not be constrained by this separate limitation.

In addition to the anti-competitive nature of this separate limitation, it should be emphasized that the existence of this provision is inconsistent with the pressures which are being brought to bear on lending institutions to provide so-called "new money" in connection with debt restructurings under the Brady Plan and is, in part, responsible for the unwillingness exhibited by U.S. lending institutions to advance new money in connection with the Mexican restructuring or to provide financial flexibility to Eastern Europe. Because the separate limitation acts as a strong disincentive to such participation by exacting a penalty for compliance with a U.S. government program which has generally been endorsed by members of the Congress, its continued presence in the tax law must be regarded as unsound tax policy.

4. Overall domestic losses

An overall U.S. loss should be subject to recapture under rules similar to those applicable to an overall foreign loss.

Tax symmetry and equity require that taxpayers not suffer a "double tax detriment" where a company has net income from foreign sources but an overall domestic loss. In such a case, the company will have both increased its U.S. taxable income by the amount of its foreign source net income and suffered a reduction in its foreign tax credit limitation, resulting in a disallowance of foreign tax credits. To eliminate this inequity, subsequent domestic income should be recharacterized as foreign source income to the extent of the prior domestic loss.

5. Repeal of *Bon Ami*

The repeal of the *Bon Ami* rule for translating foreign taxes paid by a Sec. 902 corporation was designed to equate the foreign exchange element of foreign tax credit computations with the result that would be obtained if the foreign taxes had been paid by a branch. While there may be merit in using certain foreign branch rules as a paradigm for provisions applicable to income received from foreign subsidiaries, it should be recognized that the tax deferral applicable to subsidiaries is a fundamental difference between the two forms of doing business, and the foreign taxes paid with respect to dividend remittances can consequently be computed differently without doing violence to basic tax principles. *Bon Ami* deferred the selection of the appropriate foreign exchange rate until the dividend was paid, which is consistent with deferral of taxation of the related earnings. The *Bon Ami* rule was never regarded as a tax abuse, was easy to apply, and was long established as a practical method to determine foreign tax credits.

The *Bon Ami* method had the important merit of preserving the historic effective rate of foreign tax as the benchmark for measuring whether incremental U.S. tax would have to be paid on remitted earnings. This was very important in planning international financial operations. It was scrapped to obtain theoretical consanguinity with the rule for branches. In effect, Congress fixed something that wasn't broken, creating great administrative complexity and unduly onerous costs to U.S. taxpayers in the process. Congress should reinstate *Bon Ami*.

6. Alternative minimum tax foreign tax credit

Foreign tax credits (as limited by Sec. 904 of the Code) should be allowed to offset minimum tax liability without limitation.

Under present law, foreign tax credits can offset no more than 90 percent of a taxpayer's minimum tax liability. Unlike other business tax credits whose use is limited in the minimum tax scheme, the foreign tax credit is not a preference and does not permit a corporate taxpayer to be effectively untaxed. Rather, the credit exists simply to prevent income taxed by a foreign jurisdiction from being taxed again by the U.S. The disallowance of foreign tax credits against minimum tax liability ensures international double taxation and, in so doing, undermines the basic principle of the credit.

SUBPART F

1. Active banking, financing and insurance income

Prior to 1987, the U.S. tax law permitted the exclusion from foreign personal holding company income of investment income derived in the active conduct of a banking, financing or similar business or from an insurance company's reserve investments. The exclusion should be reinstated.

In repealing this exclusion, Congress focussed solely on U.S.-controlled banks and insurance companies operating in foreign tax havens, and earnings that were manipulated for tax-motivated reasons. What Congress ignored was that the majority of U.S.-controlled foreign banks, financing and insurance companies operate through substantial presences (and are not tax haven "paper" companies), where they compete head-to-head with foreign-controlled companies, none of which are subject to a home country tax burden on their unremitted, redeployed earnings. Also ignored was the impact of banking and insurance company regulation, which often requires that these businesses be conducted by a locally incorporated subsidiary subject to local regulatory control.

The removal of restrictions within the EC on cross-border banking and insurance will open these markets to significant new competition, with the most efficient, low-cost providers being the eventual winners. Given the expertise that has already been gained in our competitive domestic markets, American companies have the potential, absent U.S. tax constraints, to be substantial participants in these fields. However, the repeal of U.S. tax deferral on active business earnings has seriously eroded the competitiveness of U.S.-controlled foreign banks, financing and insurance companies. U.S. taxes, while imposed at a relatively low nominal rate, frequently exceed the effective foreign tax rate applicable in the foreign operating jurisdiction, due to the more generous allowance of tax deductions for reserves for bad debts, pensions, losses, etc. Thus, whether competing with companies owned by residents of the operating country or with companies owned by other foreign interests, U.S.-controlled companies are subject to higher tax costs and have proportionately less working capital at their disposal than their foreign competitors. Higher tax costs also impair the ability of these companies to expand their funds held to meet foreign reserve requirements, penalizing growing financial concerns and severely hindering the establishment of new financial operations. This impediment to effective competition has already caused certain U.S. companies to curtail their presence in Switzerland and will undoubtedly result in further displacement from foreign markets. Bearing in mind that what is sought is deferral, and not exemption from U.S. tax, reinstating the subpart F exception for bona fide financial services activities is a small price to pay in the interest of U.S. competitiveness.

2. "Same country" provisions

The "same country" exceptions for subpart F insurance income and related person foreign personal holding company income, the same country requirement for application of the chain deficit rule, and the definitions of foreign base company sales and services income should be modified so as to treat members of the European Community as a single country. Standards could be set to assure that tax haven jurisdictions would be excluded from such unitary treatment in appropriate circumstances.

The forthcoming single market in the European Community militates in favor of a consistent approach under subpart F. Such an approach would free U.S. companies to structure their foreign operations and utilize their foreign capital at maximum efficiency within the Community. For example, non-same country controlled foreign corporations could assist in funding each other's working capital needs through arm's length loans, without incurring unnecessary and expensive external borrowing costs or U.S. tax on the lender's interest income on the loans. Furthermore, multiple corporate structures requiring separate corporations in each EC member country to avoid foreign base company sales or services income would be rationalized, resulting in considerable cost savings.

Enabling controlled foreign corporations to operate on an equal footing with their "borderless" European Community competitors would foster U.S. competitiveness. The ultimate economic benefit and effect on profitability of such intercompany arrangements should, over the long-term, enhance U.S. tax revenues.

3. Application of domestic life insurance concepts; application of subpart F to certain reserve investments

The current contentious debate over the pending Insurance Directive for entrance into the European Community is reflective of the substantial economic potential of this market. For American life insurance companies, the European Community offers significant new business opportunities for the export of their financial planning expertise. Ironically, it may well be the U.S. tax laws, rather than the Insurance Directive, that ultimately determine the full extent of U.S.-controlled life insurance companies' participation in this dynamic European marketplace.

Because life insurance products sold by U.S.-controlled foreign insurance companies in foreign markets are structured to comport with foreign regulatory requirements and local industry practices, they will often fail to satisfy U.S. policyholder-oriented tax rules. This is unquestionably the case with respect to products sold in the U.K. market and may be equally true throughout Europe. This fact may technically prevent the reserves and the companies from qualifying as life insurance reserves and life insurance companies for subpart F purposes. Absent relaxation of the U.S. rules in this context, foreign life insurance companies controlled by U.S. persons may be "out of business" --- if the controlled foreign corporation sells U.S.-designed, rather indigenous, life insurance products, it cannot compete with foreign-controlled life insurers. On the other hand, if the foreign company sells locally designed products, its U.S. parent faces the prospect of paying tax on premiums and investment income set aside to meet obligations to policyholders, rather than on the company's actual economic earnings. This overwhelming impediment to overseas business demands correction by excepting controlled foreign life insurance companies from the company-level tax consequences of U.S. policyholder-oriented tax rules.

4. Accumulated deficits

The subpart F deficit rules should be amended to allow all pre-1987 accumulated deficits to offset similar subpart F income earned after 1986. The current taxation of income of a foreign subsidiary should not extend to undistributed earnings that merely recoup some or all of an accumulated deficit incurred while the subsidiary was owned by the U.S. taxpayer.

5. Chain deficits

The subpart F chain deficit rule should be amended to correct a technical deficiency in the application of the rule to deficits of an upper-tier controlled foreign corporation. A deficit, otherwise qualifying under the chain deficit rule, incurred by an upper-tier controlled foreign corporation should not be reduced (and potentially eliminated) by dividends that the corporation receives from a qualified chain member.

PASSIVE FOREIGN INVESTMENT COMPANY (PFIC) PROVISIONS

The PFIC provisions were proposed to eliminate certain perceived abuses relating to minority U.S. investments in overseas mutual funds and their application should be so restricted.

If the general PFIC regime remains intact, controlled foreign corporations should be excluded from its scope. Since controlled foreign corporations are already subject to the full array of the subpart F rules (which tax passive income in any event), there is no justification for subjecting such companies to the PFIC provisions. When first proposed and enacted in 1986, the PFIC provisions were not intended to impose an additional burden on U.S. shareholders of controlled foreign corporations, given the breadth of subpart F. The PFIC provisions should be amended to reflect their original intent.

SECTION 482

The requirement that income with respect to transfers of intangible property to a related party shall be commensurate with the income attributable to the intangibles will impede the success of U.S.-based business abroad and also will provide a windfall opportunity for foreign-owned business in the United States.

Traditionally, a U.S. taxpayer could transfer intangible property to a foreign subsidiary for use in its business, and the United States would not impose tax on the transfer. Tax was deferred until earnings were repatriated as dividends or realized on the disposition of the stock of the subsidiary. In 1984 Congress amended Sec. 367 to provide that the capital contribution of intangibles to a foreign subsidiary must be treated as if the intangibles had been licensed for payments to be received over their useful life. In 1986 Congress discarded the arm's length method of determining the amounts of such payments and imposed hindsight to increase them if the intangibles proved to be more productive of income than could have been envisioned at the time of licensing.

The situation created by the 1986 amendment subjects the U.S. taxpayer to constant uncertainty whenever he tries to employ intangibles abroad. He never knows what U.S. tax may ultimately be payable, and he properly understands that adjustments to satisfy the Internal Revenue Service under the new provision will not be accorded correlative deductions by the foreign jurisdictions in which the income from the use of the intangible is derived. Further, he recognizes that no other country in the world imposes such an unreasonable state of affairs on its taxpayers. The competitive disadvantage in utilizing intangibles abroad is an extremely discouraging, if not a prohibiting, factor.

The U.S. Treasury White Paper, issued as an exposure draft for regulations to be published to implement the statutory change noted above, provides a blueprint for foreign companies to employ intangibles in the United States and avoid the major share of taxes properly due. The paper authorizes, and encourages, use of the basic arm's length return method of allocating income to a United States subsidiary which is licensing intangibles from its foreign parent. Under that method all income in excess of a contract manufacturer's rate of return would be paid as a royalty to the foreign parent, producing a dollar for dollar deduction in the United States and leaving only the contract manufacturer's profit taxable in the United States. The same result can be achieved under the cost sharing arrangements authorized by the White Paper. Further, if the foreign country in which the parent is based employs the prevalent exemption system with respect to foreign source income, no tax is paid there either. The competitive disadvantage at which a U.S. company is placed in its U.S. operations is evident and should not be allowed to continue.

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In summary, while we are concerned that tax policies emanating from the European Community and Eastern Europe may ultimately pose competitive problems for U.S. business, the most immediate as well as long-term barriers to U.S. competitiveness in these markets are created by our own tax system. Europe 1992 and the emergence of the Eastern European marketplace provide a timely opportunity and a compelling reason to remove these barriers. We ask that this Committee consider ameliorative measures to restore and improve U.S. competitiveness abroad. The Tax Council welcomes the opportunity to work with the Committee to establish a coordinated plan which balances U.S. fiscal and trade interests.

Mr. **Gibbons** [presiding]. How do you get up to 300 percent?

Mr. **Lipner**. It is quite simple. The U.S. tax law, in calculating net foreign income, disregards certain deductions that do not meet U.S. tests.

For example, a life insurance policy, sold in the United Kingdom, under U.S. rules is not considered a life insurance policy. Therefore, the reserves that you would set up as an expense when taking in a premium, you would normally under IRS rules take a deduction for the reserves you set up for future death benefits. Under U.S. rules those foreign reserves are not considered good reserves.

Therefore, the premium would be taxable and the reserves would not be deductible. The U.S. tax on economic income would be 300 percent. We found you cannot sell that type of product and pay that burden of U.S. tax.

Mr. **Gibbons**. Let me say I appreciate your coming here to educate us on this. I had thought more about the trade implications of Europe 1992 than I had about the tax implications of Europe 1992. That is an eye opener.

I am afraid that it is going to be an eye opener for the rest of the committee as well. I hope you will do the job on them that you have done on me as I listen to you. It is obvious we are not going to allow our companies to compete on anything like a level playing field unless we do change these tax laws.

As you say, it is a very difficult subject to understand and to master. I hope you will go to work on the Treasury Department down there, the IRS, our joint committee staff and our own tax staff and get them to understand the problem.

This is my initiation to it. What you have said has been very helpful.

I understand, Mr. Magnin, that you cannot operate as 12 subsidiaries in 12 countries and conduct your business efficiently having all that overhead and supervision and everything else you need to get the proper treatment under subpart F. We will have to do some rewriting. I appreciate so much what you have added to my understanding of the problem.

I am sorry. I had not let Mr. Silver give his statement. Pardon me. Go ahead.

STATEMENT OF DAVID SILVER, PRESIDENT, INVESTMENT COMPANY INSTITUTE

Mr. **Silver**. Thank you, Mr. Chairman. I am David Silver of the Investment Company Institute, the national association of the American mutual funds.

The growth of the U.S. mutual fund industry has been one of the major success stories of the 1980's. In 1980, U.S. mutual funds had roughly $100 billion in assets. Three weeks ago, assets reached the $1 trillion mark.

While the industry has met with striking success in the domestic marketplace, the picture overseas is bleak. Outside the United States, sales of our mutual funds, except for special situations, have been effectively zero. This stark contrast confirms the need and wisdom of these hearings.

The poor international sales record flies in the face of the fact that American mutual funds are particularly well suited for export. Richard Breeden, Chairman of the Securities and Exchange Commission, has targeted mutual funds as an American product that should be sold abroad because "[w]e have the best products in the world in that area." However, at present two bodies of law effectively bar American mutual funds from the export scene—foreign securities laws and U.S. tax laws. On the foreign scene, we faced a hodgepodge of local securities laws which have made it impossible to mount a unified, cost-effective marketing program. This problem is nearing resolution.

A significant milestone in mutual fund internationalization is the EC directive, effective on October 1, 1989, relating to undertakings for collective investment in transferable securities, more commonly known by its acronym UCITS. The UCITS directive, one of the first 1992 directives, is designed to harmonize the various European securities laws. Under the UCITS directive, European-national funds will be authorized for cross-marketing under one consistent body of regulation.

Since 1987, in anticipation of UCITS, representatives of the U.S. mutual fund industry have been meeting with industry leaders from Europe to discuss the possibility of a reciprocity agreement between the EC and the United States. These discussions, which have received strong encouragement from the SEC, will hopefully come to fruition in an intergovernmental agreement that would eliminate securities law barriers to the cross-marketing of mutual funds between the United States and the EC.

However, it has become apparent that U.S. funds will not be able to compete in the European Market in a meaningful way unless relief from certain U.S. tax provisions is forthcoming. Most foreign investors with the opportunity to choose between a U.S. fund and a foreign fund have an overwhelming tax incentive to invest in the foreign fund rather than the U.S. fund. In our written statement we detail the specific provisions of our tax laws which act as unintended disincentives to foreign purchases of U.S. funds.

For years, the overarching principle of U.S. mutual fund taxation has been to place U.S. mutual fund investors in the same tax position they would occupy if they purchased securities directly. Viewing the matter this way, it is obvious that this guideline will not work internationally. Putting the European investor in American mutual funds in the tax position of American investors becomes the application of a principle which has lost its conceptual rationale. To allow American mutual funds to compete in Europe, the guiding United States tax principle should be to place European investors in American funds in the same tax position as if these investors purchased European funds. Thus, changes in our tax laws are essential if United States mutual funds are to be successfully exported to Europe and elsewhere in the international markets.

Exporting U.S. money management abroad in the form of U.S. mutual funds would make good sense for our economy. It would enhance capital formation. Moreover, the billions of investment dollars which can be brought into the U.S. securities market via American mutual funds will have a particularly benign effect. Unlike direct investment by a few wealthy individuals or groups, foreign investment through mutual funds would not lead to foreign control over U.S. businesses.

I would like to thank the members of this committee for the opportunity to testify. I would be glad to respond to any questions you might have.

[The statement of Mr. Silver follows:]

STATEMENT OF DAVID SILVER
INVESTMENT COMPANY INSTITUTE

I. Introduction

Good morning. I am David Silver, President of the Investment Company Institute. I am delighted to be here today to testify on the implications of "Europe 1992" for the U.S. mutual fund industry.*/ The Investment Company Institute is the national association of the American mutual fund industry. Its mutual fund members have assets of approximately $932 billion, accounting for approximately 90% of total industry assets, which currently stand at approximately $1 trillion. There are over 30 million shareholders in U.S. mutual funds today.

While the mutual fund industry has met with striking success in the domestic marketplace, the picture overseas is vastly different. In 1989, our long term stock and bond funds had a banner year selling over $100 billion dollars in fund shares in the United States. Outside the U.S., sales, except for special situations, were effectively zero. This stark contrast confirms the need and wisdom of holding these hearings. We would like to share with you the reasons that our mutual fund industry can be the marvel of international retail financial markets and can serve as a model for the rest of the world, yet is effectively barred from the export scene. If various legal impediments were removed, we believe that investors around the world -- and particularly in the emerging European market of 320 million --would display a healthy appetite for U.S. mutual funds, which present the best opportunity for investing in the American economy.

The mutual fund industry, like other U.S. industries, is in the process of developing a strategy that would permit us to compete successfully in the European market. We are, therefore, pleased that the Committee is focusing its attention on the prospects for U.S. businesses seeking to export to the European Community. It is encouraging that the Committee is considering the specific concerns of U.S. businesses in the context of broader U.S. international and domestic policy.

II. Globalization of the Mutual Fund Markets - "Europe 1992"

Interest in marketing U.S. mutual funds abroad has paralleled the globalization of the securities markets. Technological changes permitting 24 hour worldwide trading and the growing investor demand to broaden investment opportunities have created a strong potential for exporting U.S. mutual funds.

A significant milestone in mutual fund internationalization is the EEC directive, effective on October 1, 1989, relating to "undertakings for collective investment in transferable securities", more commonly known by its acronym UCITS. The UCITS Directive, one of the first "1992" financial directives, is designed to harmonize the various European laws and regulations governing collective investment pools (which are European analogues for U.S. mutual funds) by prescribing a common level of investor protection. Under the UCITS Directive, European-national funds will be authorized for cross-marketing under one consistent body of regulation, although local (but non-discriminatory) marketing regulations can remain in place.

Even prior to the effective date of the UCITS Directive, representatives of the U.S. mutual fund industry and industry leaders from the European Community met to discuss the feasibility of a reciprocity agreement, modeled on the UCITS Directive. Such an agreement would permit European funds to be sold here and U.S. funds to be sold in Europe. I should note that these discussion have received strong encouragement from the Securities and Exchange Commission.

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*/ The Investment Company Institute also represents 177 closed-end investment companies and 13 sponsors of unit investment trusts. There are 2,961 mutual fund companies.

Our goal in various meetings since 1987 has been to ensure that the existing and respective securities law systems would not serve as unintended barriers to U.S. funds seeking to sell in Europe or to European funds wishing to sell here. Thus, the opportunity to compete on a level playing field has been our guiding principle.

In the area of securities regulation, we have cause for optimism that the ongoing discussions may lead to harmonization of our respective regulatory systems. Sharing a common concern for investor protection and in mutual recognition of the differences in structure and governance of existing U.S. and European funds, we are reasonably close to an agreement in the securities area, which we hope would be followed by swift intergovernmental negotiations and agreement.

At the same time that an agreement on securities law issues nears, it has become very apparent that U.S. funds will not be able to compete in the European market in a meaningful way unless relief from certain tax provisions is forthcoming. Existing tax laws render American funds a clearly inferior product to most foreign investors if they are given the option to choose between an American fund and a competing European fund.

We believe these tax consequences are unintended barriers and arise primarily from domestic principles of taxation which are increasingly inapposite on the international scene. We trust that one purpose of this hearing is to learn from us and others how particular tax provisions conceived in another era--certainly in the case of mutual funds--may not be appropriate in the face of Europe 1992 and other international markets.

III. U.S. Tax Laws Should Be Changed to Permit the Export of U.S. Mutual Funds

Current U.S. tax laws do not permit U.S. mutual funds to compete in the increasingly global securities markets. If the U.S. fund industry is to compete internationally, the traditional principles underlying the tax laws applicable to the domestic U.S. market for mutual funds must be altered with respect to foreign investors. International competitiveness must be added to the list of factors considered in such legislation. Although the overarching principle of U.S. mutual fund taxation has been to place U.S. mutual fund investors in the same tax position they would occupy if they purchased securities directly, it is obvious that this guideline will not work internationally. Putting the European investor in American mutual funds in the tax position of American investors becomes the application of a principle which has lost its conceptional rationale. To allow American mutual funds to compete in Europe, the guiding U.S. tax principle should be to place European investors in American funds in the same tax position as if these investors purchased European funds.

Under current tax law, foreign investors, including most European investors, have an overwhelming tax incentive to invest in a foreign fund rather than a U.S. fund. The tax disincentives to a foreigner considering investment in a U.S. fund stem from a number of different tax law provisions applicable to mutual funds.

Perhaps the most significant disincentive to invest in a U.S. fund arises from the combination of the current distribution requirement and the 15 - 30 percent withholding requirement imposed on mutual fund dividends. Many foreign jurisdictions do not require current distributions of earnings by funds located within their territory, and many impose either no tax or a very favorable tax rate on realized capital gains. Thus, the earnings of a foreigner investing in a foreign fund, in many instances, are treated as a nontaxable capital gain. By contrast, a foreign investor in a U.S. fund will be subject to a 15 - 30 percent withholding tax each year on essentially all the fund's ordinary income and short-term capital gain.

Other disincentives to foreign investment in U.S. mutual funds are created by the inability of a U.S. fund to flow through portfolio interest and short-term capital gain to its shareholders. Since both portfolio interest and short-term gain are free from U.S. withholding when paid to a foreign fund, a foreign investor has another strong incentive to invest in the foreign fund rather than a U.S. fund which must currently distribute the portfolio interest and short-term gain as a dividend subject to withholding.

Yet a further impediment to the ability of U.S. funds to compete against foreign funds arises form the restriction imposed by the so-called "short-short" test of Code section 851(b)(3). Although the repeal of this standard was approved by this Committee and the full House of Representatives in 1987, the October 1987 market break and budget summit intervened to prevent final enactment. Thus, U.S. portfolio managers must still labor under its confining restrictions. Competing foreign portfolio managers are not subject to the same constraint. The continued presence of the "short-short" test will, therefore, inhibit the industry's ability to compete with foreign funds both at home and abroad.

IV. The Benefits of Exporting U.S. Mutual Funds

Although effectively precluded from export today because of noncompetitive tax law requirements, U.S. mutual funds are particularly well suited for export. As noted by Richard Breeden, Chairman of the Securities and Exchange Commission, one area in which the U.S. excels is in its money management capability. For this reason, Chairman Breeden has targeted mutual funds as an American product that should be exported and sold abroad because "[w]e have the best products in the world in that area."

A significant benefit derived from exporting U.S. money management expertise abroad in the form of U.S. mutual funds is the ability to thereby enhance capital formation in the United States by attracting many billions of investment dollars into the U.S. securities markets. Moreover, these dollars brought into the U.S. via foreign investment in mutual funds would make the most benign contribution to our capital markets in that they would not lead to foreign control over U.S. businesses.

Direct foreign investment in the U.S. can and does result in foreign control of U.S. businesses. Japanese investors could and did buy Rockefeller Center and Columbia Pictures, but this would not occur through mutual fund investments by millions of foreign middle-class investors. The diversification requirements which are applicable to U.S. funds under Subchapter M of the Internal Revenue Code effectively limit a fund's ability to gain control of other businesses. Moreover, most funds are precluded from investing in order to obtain control over operating companies by the fund's fundamental investment objectives filed with the SEC. Thus, encouraging foreign investment in the U.S. through U.S. mutual funds will increase the supply of capital without increasing foreign takeovers of U.S. businesses.

We might note that there is already precedent for the kind of reform we are suggesting. In the Tax Reform Act of 1984, the Congress made a significant change in the taxation of income paid to foreign investors by repealing the withholding tax on portfolio interest. This change, which enhanced the ability of U.S. businesses and the Treasury to raise capital through the issuance of debt obligations, was made because Congress thought it important that such entities have access to the foreign markets as a source of capital. Concern about the cost of capital for debt financing caused Congress to take a different view of certain tax laws.

In this era of concern regarding the increasing use of debt rather than equity to finance U.S. business expansion, it is appropriate that Congress explore tax law changes that would also reduce the cost of equity capital. Encouraging foreign investment in U.S. mutual funds by modifying the taxation U.S. funds sold to foreign investors would accomplish this goal.

V. Conclusion

We appear to be on the verge of achieving a breakthrough of the securities law barriers to a reciprocal sales agreement for U.S. and European mutual funds. Under its terms, U.S. mutual funds could be marketed in Europe and European funds could be marketed here. However, all our efforts in this regard will go for naught unless there are changes in the tax treatment of foreign investors in U.S. mutual funds -- changes, we might add, which would have no negative consequences and enormous benefits to the U.S. economy. For this reason, we hope to work with the Committee and other agencies of government, including the Treasury and the SEC, in making sensible changes in the nation's tax laws that will preserve the integrity of domestic tax policy, and will help and not harm our position internationally. That being accomplished, the U.S. mutual fund industry would be ready to mount a powerful international challenge to our foreign competitors on a level playing field.

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On behalf of the Investment Company Institute, I would like again to thank the members of this Committee for the opportunity to present this testimony. I would be glad to respond to any questions you might have.

Mr. **Gibbons**. That is also illuminating. I have overlooked the obvious. I might as well admit it. I hope the rest of my colleagues have not done the same thing. I appreciate your coming to alert us. Before too much damage is done we will have to get the law changed.

As badly as we need capital there is no sense in putting a protective tariff on imported capital. It just doesn't make any sense. That is what we have apparently done in your area.

Mr. **Silver**. That is exactly right.

Mr. **Gibbons**. It is a tariff under the Tax Code. That is the same thing that we have done on debt obligations. All we succeeded in doing was running up our own interest rates and helping our competitors. Thank you for helping me understand this thing a little better.

Mr. Dorgan.

Mr. **Dorgan**. Thank you, Mr. Chairman.

I find the testimony very interesting and useful. I was just here for Mr. Lipner's and Mr. Silver's. I have had a chance to review the rest of it earlier.

The chairman and I have spent 5 years debating international competitiveness of the Tax Code. I might say that even in circumstances where the U.S. industry clearly has had a significant international advantage they have come to us and complained that they are at severe international competitive disadvantage.

Our job is to sort out the wheat from the chaff here. I don't dismiss out of hand the testimony. I think if there are and where there are specific problems we should address those problems.

I might say that this testimony comes to us from a background of years of claiming that we have been in a competitive disadvantage even in instances where it is demonstratively untrue. Having said that, I am not unsympathetic of the need to understand that if we are going to do business in certain areas, we have to be competitive. There are places where the tax laws can provide significant barriers to doing that business.

Mr. Silver, if I am a foreign purchaser of mutual funds, you are marketing your mutual funds and they are an attractive product, a foreign purchaser is interested in purchasing those funds. If we said that one of the barriers is withholding, and we will eliminate the withholding requirement, will that income be taxed somewhere?

In other words, it will not be taxed here because we will have lost it in the absence of withholding and probably not taxed in the home country of the foreign purchaser? Would you respond to that?

Mr. **Silver**. That would depend upon the home country. In Germany, for example, the taxation of German mutual funds is very similar to U.S. mutual funds, essentially transparency. So the shareholder would be taxed in Germany is essentially the same manner as a United States shareholder

Mr. **Dorgan**. Even though it was not German income?

Mr. **Silver**. Yes.

Mr. **Dorgan**. Would that be true in most countries?

Mr. **Silver**. It varies from country to country. For example, some countries distinguish between capital gains and ordinary income and some do not. Our basic point of course is that we are starting from a situation which is about as revenue neutral as you can make it.

We are not selling abroad, period. There are no foreign sales, except in special situations, of American mutual funds at all. What we are simply saying is that a system can be devised and we will be happy to work with the staff in devising the system, to put each foreign shareholder in the same situation that that foreign shareholder would occupy if he or she bought a domestic fund in that foreign country.

Mr. DORGAN. You understand that those of us who are involved in the evaluation of public policy sometimes see people come in and and plead for the lowest common denominator of standards. If possible, they would like uniform exemption internationally in order to claim effective competition. I guess our position is that we want to evaluate today in these hearings the effect of trade laws and tax laws on the ability to compete, particularly as we see new market opportunities around the globe.

We want to be sure that we do that in a fair way to everyone. This comes with the background of years and years of claims to us on the committee about the question of is our Tax Code competitive. I can recall, Mr. Chairman, back in 1985 when you and I were in this room seated across the room at a large table. I had my notebook and you had yours. We were each using the same data to come to a different conclusion. My conclusion was not only was our tax law competitive, we were in a better position than most countries we were doing business with. Yet people continued to come to us saying we want more.

Mr. SILVER. We are advocating no change in taxation of American shareholders. That would remain precisely the same.

Mr. DORGAN. Your contribution is important. We will thoroughly evaluate it. The question of whether there are conditions that affect your ability to compete selling insurance to the United Kingdom is an important question.

We appreciate your bringing it to the committee's attention.

Mr. MALETTA. Congressman Dorgan, may I assess one comment that you made? You made the comment about corporations sometimes crying wolf. I believe the United States is sometimes the haven for domestic tax income, but I don't think anyone would say the United States is more liberal than foreign industrialized countries, including the United Kingdom, Canada, and Japan.

In terms of the complexity of the subpart F that Mr. Magnin discussed earlier, we had to hire five additional tax experts on our tax department to handle one part of the tax laws, subpart F, income on a worldwide basis. I think we have reached the epitome of that when we have to hire five people to handle one subsection of the Tax Code added by the 1986 act.

Mr. DORGAN. I can't disagree with you at all. It is far too complex. My background of skepticism is from my work with State taxes where I evaluated the claims made to States by the same tax entity. They would tell our State we want you to accept apportionment and the others would say we want you to accept allocation.

I think from what limited knowledge I have that that same approach occurs in international income. Often people plead for the lowest common denominator and the lowest common denominator really creates uniform tax exemptions. We can't be the country out here saying we won't play the game. But, I would prefer to have some ascribing of income to some jurisdiction for tax purposes so either we in this country or the host country of mutual funds or life insurance would be getting tax on that stream of income.

Mr. MALETTA. We would love to have just one tax. It is the multiple levels of tax that can cause an approximately 40-percent effective tax rate.

Mr. DORGAN. Thank you.

Mr. GIBBONS. Mr. Vander Jagt.

Mr. VANDER JAGT. The contributions have been very illuminating. We thank the panelists for sharing their experience and the insights that flow from that experience.

Mr. DORGAN [presiding]. Mr. Guarini.

Mr. GUARINI. I am sorry I have not been able to be here and listen to the testimony. Being on the Budget Committee we have more arcane responsibilities than international taxes which is difficult itself as an issue.

Tell me, do people find ways and devices—and that is why you have to hire so many people not just to understand the code, but probably to find the most efficient tax mode that you can put your company in—does the present posture of our tax laws make it necessary for our country, if it is to be competitive, to find various ways around the tax laws and spend great expense and our Government in the long run doesn't reap that much benefit anyway?

Mr. MALETTA. Congressman, in our particular situation, we spent approximately $800,000 at Xerox to study the impact of subpart F on Xerox's worldwide activity. As a result the compliance effort that came out of that dictated the addition of five persons to staff.

The last 2 pages of Mr. Magnin's testimony demonstrate our existing corporate structure in the EC. We are maintaining 12 separate corporations.

Mr. GUARINI. I assume you are practicing avoidance.

Mr. MALETTA. It is not avoidance. It is the way we were existing prior to the 1986 act and we will have to maintain such a structure.

What we would like to do is to consolidate the 12 corporate entities, which include duplicative administrative, technical, marketing, and warehousing functions, into one unit to allow us to compete more effectively with our Japanese and European competitors.

Mr. GUARINI. Would the bottom line be that the final result to the U.S. Government in revenues would not be much different than if you just found other devices and ways to get around it legally so we might as well face the issue up front and change subpart F directly.

Mr. MALETTA. We don't pay any subpart F income attributable to sales and service income. We pay a U.S. tax on passive income which we earn abroad, such as interest in our various European subsidiaries.

Mr. GUARINI. It doesn't benefit the U.S. Government at all not to enact this because in the long run we probably don't receive that much in taxes anyway because you have found dozens of different countries, treaties to try to avoid the taxes we impose.

So it is a futile effort on our part. Is that a fair statement?

Mr. **Maletta**. Yes, sir, it is.

Mr. **Silver**. In the case of mutual funds, I would say the situation is quite different.

Mr. **Guarini**. Separate from the corporate problem?

Mr. **Silver**. Yes, because in the mutual fund case while some American money management has been driven offshore we cannot export to Europe or elsewhere our best products, the American mutual funds whose performance really is the wonder of the world.

We are simply barred by the tax laws from exporting those products effectively. This is a twofold loss. One is the loss of revenues that would have been earned by the managers of those funds and paid in taxes here. Second, is the loss to the American capital markets of those billions of dollars which would have been raised by the sale of those mutual funds abroad.

Mr. **Guarini**. So it is a cost that will end up on the U.S. balance sheet one way or another. Does it cause people to deal more with Switzerland and the various tax havens than would normally be the case? Are we pushing people into Switzerland, Luxembourg to have a fund that will provide more privacy?

Mr. **Silver**. Yes, Europeans instead of entering American funds, will enter European funds.

Mr. **Guarini**. Nobody likes to pay taxes so they will enter into funds that are more lenient.

Mr. **Silver**. I am looking at the investor, the customer. The German investor in mutual funds, the French investor in mutual funds is simply looking for the best investment, but one which, of course, gives him, from his perspective, a level playing field.

So if by investing in a French mutual fund he gets a better tax deal than by investing in an American mutual fund, we are effectively disadvantaged and barred from that market.

Mr. **Guarini**. He can still buy American mutual funds, set up a corporation in Luxembourg and pay no taxes anyway. Aren't there many devices that clever international tax practitioners have put together so if you are smart enough as Mrs. Helmsly says, the poor guys pay the tax, the rich guy doesn't.

You are smart about this. You know how to stay within the legal technicalities. You and I both know that there are all types of legal devices whereby people get around the American laws and fail to pay the tax, even American citizens as well as foreign citizens, because they can take advantage of the tax havens.

Mr. **Silver**. You really put your finger on it by saying "the wealthy." The American mutual funds essentially appeal to the middle-class investor. There are millions of Europeans who would invest in American mutual funds if they could.

Mr. **Maletta**. Could I add a point of clarification?

Mr. **Guarini**. Yes.

Mr. **Maletta**. You mentioned tax havens. It is very difficult in today's market for corporations like Xerox to take advantage of tax havens. We pay hundreds of millions of dollars in tax domestically and abroad. Our effective tax rate is approximately 48 percent on a worldwide basis. We have no objection to paying the full rate of income taxes once to one jurisdiction. It is just duplication that is of concern.

Mr. GUARINI. I think the large corporations have too much at stake to play the type of games that smaller companies or private investors might be tempted to. I understand that.

Mr. Lipner.

Mr. LIPNER. Congressman, I would like to give you an example vis-a-vis American Express. In 1983, we bought the largest bank in Switzerland that was foreign-owned. That bank paid taxes in Switzerland. Its business was entirely outside the United States. It had no U.S. customers.

In 1986, deferral for banks was repealed. The effective rate that Swiss banks pay is approximately 10 percent. After 1986, we, as an American company, because we owned 100 percent of the Swiss company, had to make up the difference between the 10-percent Swiss rate and the 34-percent United States rate.

In December, we announced the sale of that bank. One of the considerations going into that was the value of that bank to a U.S. shareholder versus the value to a foreign shareholder. It is worth more to a Japanese or German company than an American company. Yet it has nothing to do with the U.S. shareholder. That puts United States companies at a competitive disadvantage with the Japanese and the Germans.

Mr. DORGAN. The time of the gentleman has expired.

Mr. McGrath.

Mr. McGRATH. Let me thank the panel for their fine presentation today. It is certainly enlightening. This section of the code is probably the most complex and personally misunderstood section as far as I am concerned. I think particularly in light of what we are facing come 1992, certainly one section that might cause us great grief in that year and in the future and in relationship to our ability to compete with that section of the world, so I am delighted that you came today.

I would hope that rather then just complain about what the problems are, that you might be able to come up with some solutions that we could live with so that the next vehicle that comes along we might be able to incorporate some of your suggestions in light of the competition that will occur in 1992 into the next code operation in which we may find ourselves come maybe September of this year.

Chairman ROSTENKOWSKI. Mr. Magnin, you suggest that this committee should act now to change U.S. tax laws to reflect the changes to come from EC–1992. To date, if any progress has really been made in the EC in revising their own tax laws, if this committee acts now, will the result be that we are legislating in a piecemeal fashion on issues that will require a comprehensive approach?

Mr. MAGNIN. Mr. Chairman, I should have mentioned that current law prevents us from restructuring our business even with the current situation in the European Community. We could have structured our business more effectively if we did not have the constraints of the U.S. tax laws. The EC changes may come in 1992 or later. I think it is progressing toward its goals.

We have four manufacturing plants. We need time to do that. If we want to be efficient and if we want to have the reduced costs we need to compete in the European market in the 1990's, we need to start our restructuring now. But we cannot start doing that if we don't have some assurance that the tax laws will be changed.

Chairman ROSTENKOWSKI. What concerns me is that if we start restructuring our Tax Code without an idea of what EC-1992 is going to hold for us, I wonder if we won't be doing what we have done for the last 15 years in the Ways and Means Committee—changing the code all the time as opposed to flattening it out and having some certainty in the code so business representatives can have some certainty about what they are doing. We have enough work to do here. I just wondered whether or not we would not be anticipating some problems that would never exist.

Mr. MAGNIN. Mr. Chairman, Xerox is a U.S. corporation. In order for Xerox to start restructuring in the European Community, we are asking now for what Europe already allows its companies to do. European companies are already taking full advantage of the markets in the 12 countries. We are suggesting that the law be changed only so that the EC is treated as 1 country rather than as 12 individual countries.

Chairman ROSTENKOWSKI. Mr. Lipner, you said certain provisions of the Tax Code will hamper the competitiveness of U.S. companies in the European market. Will you expound on that?

Mr. LIPNER. I gave an example of our attempt to buy a life insurance company in Europe. We found the U.S. tax on the economic profits of that company would be 300 percent, that is the U.S. tax. The other example is the way we tax banks' earnings outside the United States, American banks that are trying to compete with the large Japanese and foreign banks, they are having to pay U.S. tax on those earnings before they bring them back to the United States.

In our case in Switzerland, we found it was better for us to sell that bank than try to compete, and one of the reasons was United States tax, which far exceeded the Swiss tax.

Chairman ROSTENKOWSKI. Let's suppose the major components of the EC have disagreements, how does that affect us? How do we adjust, where does that put us?

Mr. LIPNER. I think what Xerox is asking and the Tax Council had in our submission was that we face up to it and look at the Common Market as one economic unit. Our tax laws right now look to political units. The change we favor is based on operating economies within the EEC, and it doesn't matter what happens in the Common Market in terms of their tax laws, but from a U.S. tax standpoint we should treat the EEC as one country. It is one economic unit. It will be in 1992. And we should just modernize our laws so that U.S. companies can restructure and operate in Europe without the restrictions of the U.S. tax laws, as the Japanese companies are now doing.

Chairman ROSTENKOWSKI. I am just apprehensive about doing it now before we know what this one region for which we are restructuring our code is going to do.

Mr. MALETTA. The laws came into effect 30 years ago. Thirty years ago people were concerned about a single geographic unit, that is, Germany, Spain, Portugal, Italy. Those laws were put into place so companies did not operate through a tax haven. The law said if you are going to operate through a tax haven, we will at least tax you in the United States.

Now we are competing in the whole European marketplace. Right now we have to operate through 12 separate entities with 12 duplicate marketing and distribution staffs. We are asking that we be allowed to operate like our European and Japanese competitors, who can operate right now in Europe with one entity. They will not have to change their tax laws in 1992. If we don't, we are not going to be able to survive on a long-term basis.

Chairman ROSTENKOWSKI. Mr. Guarini.

Mr. GUARINI. Do I understand each of the 12 European countries today do not have conflicting subpart F type statutes? None of them have any type of problem on this taxation of their corporations which have to operate in different countries in the Common Market? That of Japan and the other industrialized nations of the world we are the only ones that have the subpart F. Or do other countries have it?

Mr. MALETTA. None have subpart F rules the way we do.

Mr. GUARINI. But their taxation is different. They have value added tax. They don't depend on income taxes the way we do.

Mr. MALETTA. They tax entities that operate in tax havens. That is not what we are talking about. If we operated in a tax haven, and we do not, we ought to pay at least a 34 percent tax.

Mr. LIPNER. I can state unequivocally that no Common Market or European country has subpart F rules that affect actively banking and finance at all, or insurance. If you are banking, finance, and insurance companies, you are not under that.

Mr. GUARINI. We had that debate on banking 2 years ago. We restructured our tax reform laws at that time. Now you are asking us to change it just 2 years later. That is what we got accused of doing. That is why we get accused of changing the laws too often. I am sorry we don't have time to have our laws sink and settle. If we keep changing our laws every 2 years, no tax adviser will be able to give advice and our businessmen will not be able to plan.

Mr. LIPNER. The way you have done it now, we cannot operate in Europe selling insurance, it is not feasible.

Mr. LUNDY. This does not involve cross-country situations. If you have a company in Europe operating in one country it is immediately subject to subpart F. We are the only country in the world that does that. It makes our ambition to compete an impossible task.

Mr. GUARINI. Maybe some day, under GATT, we will have some international rules of the game that will make sense to us. Until that time, I think there will be a lot of confusion.

Chairman ROSTENKOWSKI. I want to thank you gentlemen for coming this afternoon. You have been most helpful.

Our next witnesses are Mr. Skovholt, chairman of the Task Force on the European Community Internal Market Program and director, policy and strategy, corporate public affairs, Honeywell, Inc., Minneapolis, MN, and Mr. Ture, president of the Institute for Research on the Economics of Taxation.

STATEMENT OF GLEN J. SKOVHOLT, CHAIRMAN, TASK FORCE ON THE EUROPEAN COMMUNITY INTERNAL MARKET PROGRAM, AND DIRECTOR, POLICY AND STRATEGY, CORPORATE PUBLIC AFFAIRS, HONEYWELL, INC., MINNEAPOLIS, MN, ACCOMPANIED BY STEPHEN COONEY, DIRECTOR OF INTERNATIONAL INVESTMENT AND FINANCE, NATIONAL ASSOCIATION OF MANUFACTURERS.

Mr. SKOVHOLT. Thank you, Mr. Chairman.

I am Glen Skovholt, director of policy and strategy in the corporate affairs department with Honeywell.

With me today is Stephen Cooney, director of international investment and finance for the National Association of Manufacturers. My comments will summarize our written testimony which I request be included in the record.

Chairman ROSTENKOWSKI. Without objection.

Mr. SKOVHOLT. A word about Honeywell. Our presence in the European market dates back to 1934. We have a strong interest in Europe, both as an exporter and as an investor. More than two-thirds of our international sales are in Europe, where we have 16 factories and employ 11,000 people.

However, I am here today as chairman of the National Association of Manufacturers Task Force on the European Community's Internal Market Program, otherwise known as EC–1992. Over 150 companies and cooperating industry associations serve on this task force.

A lot has happened since the trade subcommittee held hearings on 1992 last March. When NAM testified last year, Fortress Europe was on everyone's lips; Eastern Europe was barely mentioned.

Our testimony listed 11 issues; today we will focus our comments on three areas of concern. Why? For one thing, we know more about the issues so are able to be more specific in our concerns. For another, several of the directives have been finalized; 1992 isn't a plan for the future; it is here and now.

Before discussing 1992, let me summarize NAM's position on three other issues being covered in these hearings.

On East-West economic relations, it is our United States economic and political interest to normalize economic relations with Eastern Europe and the Soviet Union, and new bilateral investment treaties and business agreements with Eastern European countries such as Poland and Hungary.

However, the ability of U.S. companies to do business in Eastern Europe will be seriously hampered by continued application of present export control laws and regulations. The range of products covered should be decreased through negotiations at COCOM as soon as practicable.

Foreign investment in the United States. As a matter of general policy, NAM opposes discriminatory treatment of private investment, with respect to either U.S. investment abroad or foreign investment in the United States.

In terms of specific legislation, NAM opposes the Bryant bill. Both Treasury and GAO have found that no other major industrial country requires disclosures of this type. NAM supports the U.S. initiative to include trade-related investment measures in the GATT discussions.

NAM testified on this issue last year. I would like to add that statement as part of the record.

Unfavorable taxation of U.S. multinational firms. U.S. tax laws impose an increasing burden on the ability of U.S. corporations to compete in global markets. For U.S. companies to compete effectively in EC and in Eastern Europe, comprehensive reform of U.S. taxation of foreign source income is essential.

NAM supports the comments made in the previous panel by the gentleman from Xerox especially regarding subpart F. NAM is submitting separate comments on this issue with the committee.

We support the comments of the previous panel regarding this and we will be providing more information on this in the future.

However, the primary focus of this testimony is EC-1992. NAM strongly supports the basic policy concepts behind the 1992 program. We believe it will bring major economic benefits for U.S. companies—both exporters and investors. Already, our booming export growth to the EC has turned around our trade deficit there—from a U.S. deficit that peaked at over $22 billion to a small surplus.

The EC is a critical market for many specific U.S. exports. In 1989, it took nearly half of all U.S. exports of computers and parts. The EC is also the largest market for U.S. electrical machinery and parts. And the EC takes about a third of U.S. aircraft exports and scientific and controlling instruments.

These export numbers indicate that EC-1992 can bring substantial benefits for all of U.S. industry—both companies with investments in Europe and those which service that market primarily through exports.

Although most major U.S. investors in the EC produce a large proportion of their locally sold products in Europe, it is important to recognize that most are also significant exporters to Europe. In fact, one-third of total U.S. exports to the EC is shipped directly to U.S. affiliates there.

But this overall optimistic outlook is affected by continuing U.S. industry concern over some EC proposals that may have the effect of politically inducing U.S. investment in the EC.

Let me highlight three issues that cause us concern:

First, standards, testing and certification. One of the major components of the internal market is the elimination of technical standards as a barrier to intra-EC trade. This one part of the program may affect more United States companies than any other EC-1992 issue.

Early in the development of the program, U.S. companies had serious concerns about lack of access to the European standard-setting process—particularly U.S. firms without product facilities and laboratories in the EC.

To address this issue, major steps have been taken which are described in our written testimony.

Today, the matter of mutual U.S.-EC recognition of testing practices and certification is the more troubling aspect of this issue. The EC Council of Ministers has only just approved the basic policy for testing and certification—the "global approach."

This system is not yet functioning and it is not clear yet that U.S. testing and certification bodies or U.S. manufacturers who self-certify products will be accorded mutual recognition on the same basis as organizations operating within the EC.

The issue is complex, partly because there are so many interests at stake, but it needs to be followed closely. We intend to be active on it in the weeks ahead.

Second, public procurement. Opening public sector procurement by national governments to intra-EC competition is a major element of EC-1992. Most significant, the EC is seeking to extend its authority to the sectors currently excluded from both GATT and EC rules—telecommunications, water, energy, and transport.

An important point is that the excluded sectors directive creates no new rights of access for products made outside the EC. The draft directive creates no obligation to accept a non-EC source bid, one with less than 50 percent EC-content. It also establishes a three percent preference for EC-source bids.

It is important to emphasize that the EC has explicitly stated it is willing to consider addressing the excluded sections on a multilateral basis, through GATT procurement code negotiations.

We are disappointed with the EC preference in the proposed directive but believe that resolution of the matter must come through negotiations in the GATT.

Third, rules of origin and local content. This leads to the more general question of what goods will be considered as EC-made products, and what type of barriers will non-EC goods have to face. This question is particularly relevant given the fact that remaining national quotas within the EC on non-EC products will have to be consolidated at the EC level before the internal market is fully established.

Over the last year, we have been particularly concerned by several rulings by the EC which could have the effect of shifting production to the EC, notably semiconductors. In meetings with the Commission, we have repeatedly expressed our concern over the effect that these rulings could have on investment decisions of companies.

Because of this concern, we were encouraged by the EC's statement of November 1, 1989, on rules of origin. The statement expressed support for multilateral negotiations to determine origin rules and disavowed the use of rules of origin as a means of inducing investment in the EC.

Next week our task force will be meeting to discuss these issues and others. We are appreciative of this and others on the Commission to maintain a dialog with us.

In conclusion, I would like to add one general point about EC-1992, that I think people have lost sight of in the past furor over fortress Europe, and current concerns about specific sectoral issues. The EC is not a monolith. There are many different national and commercial interests represented in every aspect of this program.

The story of this process will be in the details. The ultimate question is how effectively both the U.S. private sector and the U.S. Government can track the detailed implementation of the program, how we make our views and interests known in a timely and effective manner, and most important, how each business responds to the changing environment.

How well this is done may well determine the degree to which United States industry and its customers in Europe benefit from EC-1992.

[The statement and attachments of Mr. Skovholt follow:]

TESTIMONY OF

GLEN J. SKOVHOLT
DIRECTOR, POLICY AND STRATEGY
CORPORATE PUBLIC AFFAIRS
HONEYWELL, INC.
AND
CHAIRMAN, TASK FORCE ON THE EUROPEAN COMMUNITY
INTERNAL MARKET PROGRAM
NATIONAL ASSOCIATION OF MANUFACTURERS

ON

EUROPE 1992:
THE IMPLICATIONS FOR U.S. TRADE AND INVESTMENT

BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

JANUARY 30, 1990

Mr. Chairman, I am Glen J. Skovholt, Director for Policy and Strategy in Corporate Public Affairs, Honeywell, Inc. Honeywell is a U.S. corporation offering a diversified line of electronic-based products and services to worldwide markets. We do business in over 90 countries worldwide, with $1.6 billion in international sales last year.

Honeywell has strong interests in the European Community both as a U.S. exporter to the EC market and as a company which has long had a substantial presence in Europe in all phases of our manufacturing and service activities. More than two-thirds of our total sales outside the United States are in Europe, where we have 16 factories and employ 11,000 people.

For this reason, I was pleased to work with the National Association of Manufacturers as chairman of its task force on the European Community's' Internal Market Program, know in shorthand as "EC-92." Over 150 companies and cooperating industry associations have worked with us in this group. This task force continues to focus on some of the priority issues that were identified in the NAM report, EC-92 and U.S. Industry, which I presented to the Trade subcommittee of this committee last year. More recently, I have led a group of Task Force members on a visit to the offices of the European Commission in Brussels.

My comments will focus on the major issues of concern today to NAM's members regarding EC-92, and which we have discussed recently with the European Commission. However, the focus of these hearings is broader even than the very broad subject of EC-92. NAM has strong interests in the issues of East-West trade, foreign direct investment in the United States and tax matters related to some of these international issues. For the record, let me summarize the present NAM position on all of these matters:

-- EC-92: NAM strongly supports the basic policy concepts behind the 1992 program. We believe that it will bring major economic benefits for U.S. companies -- with regard to both exports and total European sales. But there are also some specific proposals which cause us serious concern. I will elaborate on these points in this testimony.

-- East-West Economic Relations: NAM members believe that it is in the U.S. international economic interest and our political interest as well to normalize and regularize economic relations with Eastern Europe and the Soviet Union, given the recent changes in the political structure in those countries. This means that NAM supports the concept of a trade agreement with the Soviet Union. We have also supported in discussions with the State Department the concept of new bilateral investment treaties and business agreements with Poland, Hungary and potentially the other Eastern European countries. And NAM has testified at OPIC's recent annual public hearing in favor of the recent congressional decision to allow OPIC to begin operations in Poland and Hungary.

One point that has also emerged in these discussions is that NAM members believe that their ability to do business in Eastern Europe will be seriously hampered by the application of our present export control laws. We therefore hope that then range of products covered by such laws will be decreased in keeping with a more realistic assessment of U.S. national security needs and that a harmonized international list of controlled products and export practices will be developed as soon as practicable.

-- Foreign Investment in the United States. As a matter of general policy, NAM opposes discriminatory treatment of private investment, with respect to either U.S. investment abroad or foreign investment in the United States. We believe that the best way to deal with the U.S. trade and balance of payments deficits is to reduce the U.S. federal budget deficit and increase our exports -- not to discourage foreign investment that is seeking legitimate market opportunities in the United States. One exception in this area is inward investment that may endanger U.S. national security. NAM did support the provisions of the 1988 Trade Act on this subject.

Earlier in this series of hearings, Representative Bryant testified on his Foreign Investment Disclosure Bill. NAM opposes this bill. Both the U.S. Treasury Department and the General Accounting Office have found that no other major industrial country requires disclosures of the type sought by Representative Bryant. NAM believes his bill is discriminatory and unnecessary. NAM has not yet taken a position on the investment reciprocity bill introduced by Representative Campbell, who also testified earlier. However, NAM fully supports the U.S. initiative to include trade-related investment measures in the GATT discussions, and would note that this concept is now supported in the GATT by Japan and the European Community.

-- Unfavorable Taxation of U.S. Multinational Firms. U.S. tax laws impose an increasing burden on the ability of U.S. corporations to compete in global markets. This process has been particularly severe since the 1986 tax "reforms." Most EC countries have tax systems that attempt to encourage exports, to minimize double taxation and to lower the cost of capital. U.S. tax laws and regulations tend to have exactly the opposite effect. For U.S. companies to compete effectively in the EC and in Eastern Europe, comprehensive reform of U.S. taxation of foreign source income, including Subpart F, is absolutely essential.

In addition, the United States needs to negotiate aggressively the reduction of present withholding taxes imposed by EC countries on U.S. companies. When withholding taxes are eliminated between EC countries, it is critical that they be eliminated for dividend, interest and royalty payments to the United States as well. In order to strengthen the U.S. negotiating position, it is critical that Congress not unilaterally act to override or repudiate existing tax treaties.*

The EC-92 Market Opportunity

The primary focus of this testimony is EC-92. The first thing that you need to look at, from the U.S. perspective, is the scale of the market opportunity. By the European Commission's calculations, enactment of the full 1992 program can give a one-time boost of 5 percent or more to the total EC domestic product. The Commission's own more recent growth estimates and an analysis recently presented by the National Bureau of Economic Research indicate that this view could be conservative. Moreover, EC economic statistics indicate that this growth is led by new investment in industrial equipment. One-third of total U.S. exports consists of manufactured capital goods, so this plays right to our strength. Already, our booming export growth to the EC has turned around our trade deficit there -- from a U.S. deficit that peaked at over $22 billion, to a small surplus in 1989. This accounts for over 40 percent of total trade deficit improvement over the past two years.

While U.S. exporters should seek markets wherever they can find them, for the foreseeable future the EC may remain the key growth market overseas for U.S. industrial companies, especially if it becomes more dynamic and open. Europe is our most important regional export market, and will remain so indefinitely. The largest share of total U.S. exports to any single country or region -- nearly 25 percent -- goes to the European Community. This is slightly more than our total exports to Canada. Japan takes only 12 percent of our exports and all the rest of the industrializing nations of East and Southeast Asia another 15 percent. All of Latin America, including Mexico, takes only 12 percent. Most importantly, no other large regional market approaches the level of economic integration found in Europe today, much less what is being contemplated by 1992.

The EC is a critical market for many specific U.S. exports. In 1989, nearly half of all U.S. exports of computers and parts went to the EC -- that's a projected total of over $10 billion in exports of that product to the European Community. The EC is also the largest market for U.S. electrical machinery and parts, a category that includes semiconductors. The EC takes about a third of U.S. aircraft exports, despite heavy subsidies to its own aviation industry. And in scientific and controlling instruments, where U.S. manufacturers maintain a strong trade surplus, 35 percent of all exports go to the EC.

Note again that these products are all capital goods, and that's why I especially see a major opportunity for U.S. manufacturers. Although we have the world's largest trade deficit -- over $100 billion again in 1989 -- we are a strong export competitor in capital goods. These are primarily products used to make other goods or provide services. While we have large trade deficits in manufactured consumer and automotive goods, we still have a surplus in capital goods. Europe will need high-quality, price competitive U.S.-made capital goods if it is to remain competitive in world markets, and that is the prime objective of EC-92.

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*Although not testifying today, Paul R. Huard, NAM's Vice President for Taxation and Fiscal Policy, will file a separate written statement elaborating in more detail the points summarized in this paragraph.

Interests of U.S. Exporters and Investors -- The "Forced Investment" Issue

These buoyant U.S. export numbers indicate that EC-92 will bring substantial benefits for all of U.S. industry -- both companies with investments in Europe and those which service that market primarily through exports. Our members, however, have been concerned by specific EC policy proposals which could have the effect of inducing investment in the EC and moving investments there, as opposed to continuing to export to the EC.

Let's look more closely at the relationship between trade and investment. I've already noted that Honeywell has a major investment and manufacturing presence in Europe. For all U.S. manufacturers, total holdings in the EC were officially valued at $65 billion at the end of 1988. That's half the total value of all U.S. companies' manufacturing investment abroad.

Although most major U.S. investors in the EC produce a large proportion of their locally-sold products in Europe, it is important to recognize that most, like Honeywell, are also significant exporters to Europe. In fact, a third of total U.S. exports to the EC is shipped directly to U.S. affiliates there.

I feel that there is not as large a difference as some suggest in interests between U.S. companies with investments in the EC and those that service the market primarily through exporting. Many U.S. exporters directly or indirectly sell their products to or through large U.S. investing firms. Most U.S. investors do some significant exporting to the EC market. And in both types of activities, it is critically important to maintain close and positive relations with customers, distributors and joint venture partners that may be EC-headquartered companies. This point links up with the importance of U.S. capital goods exports. In seeking to exploit new EC market opportunities, U.S. producers now in Europe have continued to import into Europe U.S.-made components, systems and capital goods products.

But this optimistic outlook is affected by continuing U.S. industry concern over some EC proposals or policies that may have the effect of politically inducing U.S. investment in the EC.

Right now, probably the three issues causing most concern are:

Technical Standards, Testing and Certification -- The harmonization of technical standards, testing and certification which can have a major impact on current and future access of U.S. goods to the EC market.

Public Procurement -- The enhancement of exisitng EC rules on the opening of member government procurement and extension of EC rules to the sectors presently excluded from GATT or EC discipline. Current proposals include new "EC content" rules that may disadvantage U.S. exports.

Rules of Origin and Local Content -- The development of EC rules that determine whether goods are of EC origin, for the application of specific tariffs, trade benefits or penalties, may also directly or indirectly discourage exporting from the United States.

In the balance of these comments, I will focus on these three issues, because I believe that they may have the most impact on U.S. exporters to the EC.

Technical Standards, Testing and Certification

One of the major components of the internal market is the elimination of differences in technical standards, that serve as barriers to intra-EC trade. This process may affect more U.S. companies than any other EC-92 issue.

The technical standards aspect of EC-92 can only be understooc in view of the failures of previous efforts to eliminate internal market barriers by harmonizing national product standards. There were efforts to define specific EC-wide codes for goods on a product-by-product basis. But progress was so slow, that it could not even keep pace with the development of new products in the dynamic European economy.

Then the European Court of Justice decided that member governments could not use their national standards as a basis for keeping out goods that were legitimately sold and consumed in other member countries. This decision -- the Cassis de Dijon decision -- meant that EC member countries had to accept some expeditious means of developing EC-wide minimum product standards. The alternative would be goods sold in their national markets that were produced under conflicting standards or no standard at all.

The principle of the new EC approach to standardization is that any product which can be legally sold in any member state will be freely marketable elsewhere in the EC, unimpeded by diverse national standards or testing and certification procedures. The emphasis in this approach is on "mutual recognition and equivalence," as opposed to the negotiation of detailed product and process standards. This involves a new expedited EC standardization procedure based on EC "framework" directives. Any product sold in any country that meets the "essential requirements" of these framework directives can be sold in any other EC country. If a product is not covered by a framework directive or other EC regulation and if it can be legally marketed in any one country, then it can be sold throughout the EC.

Also, EC governments will be required to accept product test certificates issued by testing laboratories in other member countries, if they meet agreed minimum standards. Beyond the establishment of minimum essential requirements, the establishment of harmonized EC standards is not being undertaken by the European Commission itself or the member state governments, but by the Europe-wide private standards bodies, known by their French acronyms as CEN (for most manufactures) and CENELEC (for electrical products).

In principle, the adoption of common standards is widely seen by U.S. companies in Europe as a major benefit. U.S. companies with production facilities in Europe believe that they will be able to rationalize production across national frontiers to a much greater degree than at present. And whatever standards are adopted for a product, the potential U.S. exporter will be assured that complying with these standards provides access to the entire EC market. Moreover, under its mandate from the EC, CEN/CENELEC is committed to adopt international standards where they already exist, if appropriate, and to seek to have any proposed new standards negotiated at the international level. Establishment of uniform testing procedures and mutual recognition within Europe of certification from the different member states can produce similar benefits, especially if this can be extended to testing and certification done within the United States.

But U.S. companies have had serious concerns about lack of access at all stages to the European standard-setting process and testing and certification systems. These concerns have been voiced particularly by U.S. firms without production facilities and laboratories in the EC. To resolve this issue, several major steps have been taken so far, thanks in part to active efforts by the U.S. Department of Commerce.

First, CEN/CENELEC has started issuing a monthly publication updating all stages of all product standards activities. Secondly, CEN/CENELEC agreed to receive comments from non-EC member standards bodies of the International Standards Organization and the International Electrotechnical Committee. Further, CEN/CENELEC agreed to allow its technical committees to consult on specific products for which there may be questions from non-EC standards bodies. Third, the American National Standards Institute, which represents organizations setting over 90 percent of U.S. standards and is the U.S. national ISO/IEC member body, has upgraded its international representation activities, including the opening of an office in Brussels to consult with CEN/CENELEC regarding mutual concerns. With these improvements, it now remains to be seen how effective the new access will be for U.S. companies -- and how effectively they avail themselves of it.

Today, the question of mutual US-EC recognition of testing practices and certificates is the more troubling aspect of this issue. The EC Council of Ministers has only just approved the basic policy for establishing a harmonization of standards for testing practices and procedures, and the mutual recognition of certificates within the EC -- the "Global Approach." This system is not yet functioning within the EC. It is not clear yet that U.S. testing and certification bodies, or U.S. manufacturers who self-certify products, will be accorded mutual recognition on the same basis as organizations operating within the EC. In part, this is because the EC Global Approach will require some form of balanced access to non-EC systems that seek to renew existing bilateral recognition agreements or establish new ones with the EC.

Public Procurement

The European Commission's determination to open national governments' public sector procurement to intra-EC competition is another major feature of EC-92. This process is effectively to be completed in two steps.

First, existing directives on public works and public supply contracts have been strengthened. The bidding process in each EC member state must be made completely transparent. Single-bid or no-bid public contracts without adequate public notice are to be eliminated. Since manufactured products in many of these areas are also covered by GATT public procurement rules, there should be no allowance of discrimination against U.S. producers, if EC policy really succeeds in making the process more open.

Second, the EC is attempting to extend its regime over public procurement to the sectors currently excluded from both GATT and EC rules -- telecommunications, water, energy and transport. This subject is more controversial, and approval of the basic directive by the EC has not been completed.

The most important point for U.S. companies in this "utilities" directive is that the proposed new rules in themselves create no new rights of access for products made outside the EC. In opening utilities procurement within the EC, the directive creates no obligation for purchasing authorities to accept non-EC source bids (non-EC source means less than 50 percent EC content). Moreover, if two bids are within 3 percent, an EC member government must discriminate against a bid which is not at least 50 percent EC content.

It should be pointed out here that the 3 percent margin of preference is substantially smaller than that provided in various U.S. "Buy American" provisions in publicly-funded U.S. procurement. But unlike "Buy American" rules, the European purchasing authorities will have no obligation to choose a non-EC source option, if that bid is the lowest even given the preference margin.

In developing these rules, the EC has explicitly indicated that it is willing to consider open access on a multilateral basis, through negotiations under the GATT procurement code. The view expressed by many of our members to date is that while they are not pleased with the local content rules included in the proposals regarding public procurement in the presently excluded sectors, the principle of opening these markets within the EC and the willingness to negotiate the opening of these sectors to other signatories of the GATT procurement code are steps forward. In the meantime, however, we believe that U.S. goods that are potentially attractive in public procurement markets will be disadvantaged in the EC marketplace, because of uncertainty over future procurement rules and preferences.

Rules of Origin and Local Content

The question of EC origin in public procurement leads to the more general question of what goods will be considered as EC-made products, and what types of barriers will non-EC goods have to face after 1992. This question is particularly relevant given the fact that remaining national quotas within the EC on non-EC products will have to be consolidated at the EC level before the internal market is fully established. For some producers outside the EC this presents the specter of new barriers in countries where they had not existed before. The major sectors which could be affected are cars, textiles, footwear and consumer electronics. Also, for the purpose of implementing such quotas, as well as policies such as the EC content rule in public procurement, there will have to be a consideration of what determines EC origin.

Over the past year, for example, we have been particularly concerned by several rulings which may have the ultimate effect of encouraging a shift of production to the EC. The major question involves semiconductors, where the EC has decided that the most important and expensive stage of the production process -- wafer fabrication -- must be performed in the EC to avoid the EC's normal 14 percent duty. This step may have the effect of forcing U.S. semiconductor producers to establish expensive new production facilities in the EC, even though they have excess capacity in the United States. This decision may also have important ramifications for the question of origin of downstream products using semiconductors (printed circuit boards, and ultimately computers). Also, we are closely watching how the EC will implement its indicated decision to extend Japanese car quotas, which exist in some form in four major markets (Italy, Spain, France and Britain) to the full EC level. For example, if a Japanese manufacturer used significant U.S. content in a car shipped to or assembled in the EC, would this car be covered by any EC-Japanese quota or agreement?

With respect to questions on the rule of origin and the idea of forced investment, the NAM Task Force reacted positively to the EC's statement of November 1, 1989 on these subjects. This statement indicated EC acceptance of the idea -- originally proposed by the U.S. Trade Representative -- of negotiations on establishing multilateral discipline over origin rules. It also abjured any use of rules of origin as a mean of inducing investment in the EC. I have attached to this testimony a copy of an NAM letter reacting to this EC policy statement.

Final Comments

In conclusion, I would like to add one general point about EC-92, that I think people have lost sight of in the past furor over "Fortress Europe," and current concerns about specific sectoral issues. The EC is not a monolith. There are many different national and commercial interests represented in every aspect of this program. There is also an institutionalized conflict between the central organs of the Community, especially the European Commission, and specific member governments that may wish to protect specific industries or regions, for all the usual political, social and economic reasons. The story of this process will be in the details. The ultimate question is how effectively both the U.S. private sector and the U.S. government can track the detailed implementation of the program, and make our views and interests known in a timely and effective manner. Our effectiveness in doing this may well determine the degree to which U.S. industry and its customers in Europe benefit from EC-92.

NAM
National Association
of Manufacturers

January 12, 1990

The Honorable Frans H.J.J. Andriessen
Vice President and Commissioner
Commission of the European Communities
200 Rue de la Loi
1049 Brussels, Belgium

Dear Mr. Vice President:

The National Association of Manufacturers represents over 13,000 member companies and their subsidiaries, which account for over 80 percent of U.S. manufacturing production, U.S. manufacturing employment and U.S. manufactured exports. The membership of the NAM also includes virtually all of the companies of U.S. origin with major investments in manufacturing facilities in the European Community.

The overall NAM view on the EC 1992 single market program is positive. We believe that this program will be a major benefit to the people of Europe, while also increasing world trade opportunities. As stated in public NAM reports and documents, including testimony before the U.S. Congress, we believe that all U.S. industry can benefit from 1992 -- both companies with investments in Europe and those which service that market primarily through exports.

Our members, however, have been concerned by specific EC policy proposals which could have the effect of inducing investment in the EC and moving investment there, as opposed to continuing to export to the EC. A major issue in particular has been the EC decision on the rule of origin of semiconductors, as well as the pending rule on printed circuit boards. We believe that concrete steps should be taken to eliminate any adverse effects on U.S.-made products that might be inherent in the current rules applied to semiconductors or that might result from any rules of origin for printed circuit boards.

This industry is not only important in itself, but there could be further decisions on "downstream" products of which semiconductors are major components. And, of course, other industries are concerned that rules of origin for their products may also be changed, in a way that would force costly alterations in product sourcing. The EC content provision in the public procurement directive for the utilities sectors, now in the final stages of adoption, in particular makes definition of origin a crucial issue for many industries and products.

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It is in this context that we were reassured by the Commission statement of November 1 regarding the rule of origin question. First, we believe that the Commission's decision to accept the principle of multilateral discipline over the rule of origin is a positive step. We also believe that the GATT is the appropriate forum for the development of multilateral rules. The details of the U.S. and EC approaches are less important initially than mutual acceptance of the multilateral concept. The issues of transparency and predictability raised in the statement by the EC are also important ones from the U.S. industrial side.

Secondly, we were encouraged by the statement that, "The European Community must continue to apply rules of origin in a way that will not affect trade or investment." Our hope is that this view will be applied clearly and consistently in future origin decisions. To that end, we believe that it would be helpful for the EC to repeat this policy statement in a broader context. Certainly, when representatives of our organization's EC-92 Task Force visited Brussels in September 1989, it was emphasized in all meetings that there will be no general policy of "forced investment" as part of 1992. This position needs to be made clearer for the general international business community.

During our Task Force visit, members of the Commission staff were willing to discuss various aspects of the rule of origin issue, regarding both semiconductors and other products, with members of NAM's EC-92 Task Force when they visited Brussels. Again, the Task Force has recently had an opportunity to discuss this subject in detail with representatives of both the U.S. government and the EC Delegation in Washington. We are very appreciative of the efforts that the Commission has made to explain its position to us.

We would therefore appreciate your consideration of these views, and would be pleased to provide any further information on our organization's position. Our overall goal remains one of supporting a successful 1992 program and improved US-EC economic relations.

Sincerely,

Jerry J. Jasinowski
Jerry J. Jasinowski
President
National Association of Manufacturers

Glen J Skovholt
Glen J. Skovholt
Honeywell, Inc.
Chairman, NAM Task Force on the Europe 1992 Single Internal Market Program

TESTIMONY ON THE FEDERAL COLLECTION OF INFORMATION ON FOREIGN INVESTMENT IN THE UNITED STATES

BY
JERRY J. JASINOWSKI
ON BEHALF OF THE
NATIONAL ASSOCIATION OF MANUFACTURERS

BEFORE THE
COMMITTEE ON COMMERCE, SCIENCE AND TRANSPORTATION
UNITED STATES SENATE

JULY 11, 1989

Mr. Chairman, members of the committee, I am Jerry Jasinowski, executive vice president and chief economist of the National Association of Manufacturers. I appreciate this opportunity to testify today on an issue that has become extremely important to our member companies, as well as to the economic future of our country.

This hearing is examining legislation related to the reporting of foreign direct investment in the United States. Previous congressional witnesses today discussed two bills: (1) The Bryant-Harkin bill represents a comprehensive foreign ownership disclosure approach. It is an amended version of the foreign investment disclosure provision that Congress rejected last year as part of the Trade Act. NAM supported the final Trade Act passed by Congress, but strongly opposed this provision. In common with other major business organizations, we continue to oppose the amended Bryant-Harkin bill.

(2) Senator Murkowski has adopted a different approach in his bill, S. 856. Instead of requiring far-reaching changes in reporting as in the Bryant-Harkin bill, S. 856 identifies some problems and addresses them by amending the existing International Investment and Trade in Services Survey Act (henceforth Investment Survey Act). I am not yet prepared to endorse S. 856 on behalf of NAM. But we believe that it represents an appropriate type of legislation that should be considered at this time with respect to reporting on foreign investment.

Today, the United States certainly has the most advanced and detailed system in the world of public reporting on inward foreign direct investment. This has been confirmed by the Director of the UN Center on Transnational Corporations. We believe that existing federal reporting captures major trends accurately and in a timely manner. Therefore, we oppose any wholesale or radical changes in the collection and reporting of data. But we are willing to work with Congress and the new Administration in reviewing the adequacy of present data in all respects, and to work with this committee in particular with respect to issues such as those raised in S. 856.

I would also like to address in this testimony the more general question of restricting or channeling foreign investment, as has been suggested by a number of commentators. NAM opposes general efforts to restrict foreign capital inflows for economic reasons. We believe instead that U.S. policy should aim for the early elimination of the federal budget deficit, and the reduction of the trade deficit through U.S. export growth and implementation of U.S. trade laws. Foreign direct investment in the United States in the 1980s has been in part a natural response to the sharp increase in these deficits, although we believe that foreign companies would have sought to increase their investments in the United States in the 1980s in any case, because of market opportunities here.

The major qualification to our support of unrestricted investment inflow lies in the area of national security. NAM last year supported Senator Exon's amendment reported by this committee and subsequently added to the Trade Act. We believe that this provision gave the President full and adequate legislative authority to review mergers, acquisitions and takeovers involving foreign firms in the United States when such transactions have direct national security implications, and to alter or deny such proposed transactions.

Now I would like to discuss our views on the proposed legislation and foreign investment in a little more detail.

NAM Opposes the Bryant-Harkin Bill

The Bryant-Harkin bill would require the special registration by foreign persons of any acquisition of a "significant" interest in a U.S. property, or of a controlling interest in a U.S. business enterprise. It discriminates against foreign investors, since it would require foreign persons and companies in many cases to disclose a wide range of important and propriety business information that U.S. companies in like circumstances are not required to provide or disclose. The U.S. business community and the U.S. government have opposed discriminatory reporting requirements and investment policies in other countries, because they are frequently used to hamper both trade and the efficient management of international business enterprises. We believe, therefore, that passage of this bill is not only bad policy for the United States, but that it would harm our continuing negotiations in the GATT and the OECD to reduce such barriers.

But even where extensive and discriminatory foreign government reporting requirements exist, the confidentiality of business information is respected. Contrary to the assertions of the authors of the bill, there is no international precedent for this bill. This point was made clearly in the December 1988 Treasury Department survey of foreign government investment reporting an disclosure rules. The Treasury study concluded that no other major industrial country government "keeps a public registry for specific investments nor discloses detailed information even to selected researchers or GAO counterparts."

The Bryant-Harkin foreign ownership disclosure proposal would require public disclosure by the foreign entity of:

-- "Details regarding acquisition of the property; The size of the interest acquired in the United States property and the price paid for the interest;"

-- Detailed operating and financial information on the acquired enterprise, as verified by outside audit;

-- Identity, nationality, compensation and related business interests of executive officers and directors.

Moreover, the registered investor has the difficult and sensitive duty of providing annual statements on the "market value" of all U.S. assets. There is no similar "market value" estimates required on reports filed by U.S.-owned companies. Competitors or potential acquirers could benefit substantially if such data were to fall into their hands.

The high probability of disclosure of proprietary information is the worst and most damaging aspect of this legislation. Although the authors claim that for most companies this bill only requires "postcard" registration of data that was publicly available and harmless anyway, even they appear to recognize this point. Thus, the present bill differs from the originally proposed trade bill provision by supposedly "limiting" disclosure of companies' confidential and proprietary information to five classes of recipients:

-- All officials and functionaries named in the bill "including consultants and persons working on contracts" pursuant to the bill;

-- All committees and subcommittees of Congress, with such privacy protection procedures as established by each committee on its own;

-- The General Accounting Office, with privacy protection as established by the Comptroller General -- but with the GAO also allowed to disclose any information to Congress;

-- All states, via one designated agency in each state, with each state establishing its own privacy protection procedures in conformity with its interpretation of the GAO rules;

-- "Persons performing qualified research under procedures established by the Secretary of Commerce by rule or regulation" --this last designation is quoted in full because I don't think anyone has any idea what it means.

This list of potential recipients is so broad and ambiguous as to be meaningless as a restrictive device. Even the rules of disclosure could be as varied, for example, as the positions taken by fifty different state legislatures.

One other new aspect of this bill deserving of attention is a change in the penalty provision. What if a foreign company fails to report the required data -- or, more likely, reports data that is subsequently deemed inadequate or inaccurate (and remember this includes determination of "market value" of all assets). For the second offense, if it is considered "a pattern or practice of violations," the punishment is the equivalent of the death penalty: forfeiture of all U.S. assets subject of the reporting violation. Expropriation as a penalty for reporting violations is not only harsh, but probably violates international law.

One final issue that I would like to mention in discussing this bill is the alleged exemption for companies filing SEC reports, which NAM President Alexander B. Trowbridge, discussed when he testified before this committee last year on the earlier version of the bill. I will not repeat his comments in detail, but instead remind the committee that he established two important points. First, even most publicly-traded companies would not be covered by the exemption. Foreign issuers registered with the SEC that trade by selling debt securities or American depositary receipts (ADRs) are not covered by this exemption, for example. Secondly, the existence of an exemption for some SEC reporters does not reduce the discriminatory effect on privately-held companies. This could especially affect many smaller Canadian companies now guaranteed non-discriminatory treatment under the U.S.-Canada Free Trade Agreement.

The justification for such discrimination is that more information on investors is needed in the public interest. In fact, as the SEC and other data-gathering agencies under Administrations of both parties have indicated, there is at present adequate authority for gathering information on the growth of foreign direct and portfolio investment in the United States. In response to comments from NAM and other organizations, the publication of meaningful aggregate investment statistics based on the collection of such data has been speeded up in recent years. As Professor Douglas Woodward, one of the other witnesses scheduled to testify today, indicates in his new book, The New Competitors, the threat of such disclosure would probably worsen, not improve, the quality of the data. Moreover, the publication of such ordinarily confidential data could easily lead to the harassment of individual companies and the discouragement of individual investments.

NAM Views on the Murkowski Bill (S. 856)

It is our view that concerns with gaps and inadequacies in foreign direct investment data, or the way the data are reported, can best be addressed by targeted legislation such as S. 856. The principal concern in this bill is the role of governments in foreign direct investment. Senator Murkowski would like to see more public reporting on this aspect of the data. He also encourages increased interchange and compatibility between Census Bureau and Bureau of Economic Analysis data within the Commerce Department. S. 856 also seeks to allow access to BEA confidential data for the Committee on Foreign Investment in the United States (CFIUS). This is the interagency national security review committee first established by President Ford. It has been raised to the Cabinet level and designated by President Reagan as responsible for the national security review of foreign acquisitions under the Exon Amendment to the Trade Act. S. 856 explicitly retains all the tough confidentiality provisions of the existing Investment Survey Act.

With respect to the substance of the bill, both official data and an informal review of major investments indicate that foreign governments have played a decreasing role in the recent rapid rise of foreign investment in the United States. Such investment has primarily been undertaken by private enterprises for commercial gain. Moreover, CFIUS can already make any foreign acquiring party provide any confidential ownership or other data for review, as a condition for approval of a transaction.

However, there may clearly be an issue of substance here. We would not oppose further congressional examination of this issue. With respect to any legislation, including S. 856, we would submit two primary concerns from the perspective of NAM member companies:

-- The legislation should try to avoid encouragement of discriminatory and retaliatory reporting or ownership rules against U.S. companies investing abroad;

-- The legislation should not in any way increase the likelihood of the disclosure, inadvertently or otherwise, of confidential and proprietary corporate data.

NAM Opposes Direct Restrictions on Foreign Capital

On the broader issue of foreign investment, our organization has always supported the free international flow of capital when it follows economic opportunity, allowing for appropriate monitoring of legitimate national security concerns. That is still our position.

Discriminatory treatment is contrary to the open market principles that encourage business investment in the United States in the first place. A discriminatory policy also ignores the possibility that such restrictions will justify an increase in foreign restrictions on U.S. investment abroad, just when it appears that we are making some progress in convincing other countries to eliminate investment restrictions that interfere with U.S. exports. This has also long been a position held by Administrations of both political parties.

Today we see three major initiatives aimed at liberalizing trade and investment regimes around the world. Each of these would be imperilled by major new discriminatory U.S. reporting requirements or other more directly restrictive policies.

-- Efforts to include discipline over "trade-related investment measures" (TRIMs) in GATT trade rules. Some type of ban has in principle been accepted by Japan and the European Community, as well as some of the developing countries. The major question now is the scope of the discipline and the definition of TRIMs to be included.

-- The "structural impediments initiative" (SII) added to the Bush Administration's "Super 301" actions aimed at Japan. The SII specifically names controls and prohibitions on U.S. direct investment in Japan. Both de jure and de facto investment controls in Japan have been used to keep U.S. goods and U.S. companies out of the Japanese market, especially by preventing acquisition of Japanese companies with their existing distribution networks.

-- Further liberalization of the OECD investment codes. To quote from the just-released OECD ministerial report on increasing economic policy surveillance: "International direct investment has risen sharply since the mid-1980s in the wake of significant progress in dismantling barriers. These trends have been encouraged by application of the OECD [investment codes].... Recently, there have been disturbing signs of trade protectionist sentiment spilling over to the investment field. The scheduled 1990 review of the OECD 1976 Declaration and Decisions on International Investment and Multinational Enterprises will therefore provide a timely opportunity for governments to give further impetus to liberalization in this area."

Thus we have major liberalization initiatives going forward at the bilateral, OECD and GATT levels. These initiatives are important, we believe, because open international investment flows serve the U.S. economic interest in two fundamental ways.

-- Free investment flows help ensure that as we eliminate our trade and current account deficits, foreigners contribute with productive direct and portfolio equity investments in U.S. industry -- not mountains of interest-bearing loans such as those accumulated by the Latin American debtor nations.

-- Global investment liberalization combined with growing markets and a competitively priced dollar will ensure continuation of recent strong U.S. capital goods exports --so far the strongest element in the U.S. trade recovery.

With an officially estimated net international debt position of $533 billion at the end of last year, the United States has for several years been the world's largest debtor nation. Important and reasonable questions have been asked in the United States about the strong growth of foreign direct investment inflows, and their implications for the future of U.S. international competitiveness. In part, these questions derive from the unaccustomed U.S. position as a net international debtor and the rapidity of the change. From a $140 billion credit position in 1981 -- the world's largest -- the United States has swung sharply in the opposite direction by $670 billion in the 1980s.

During this period, foreign direct investment in the United States grew from $104 billion to $329 billion, while the U.S. direct investment position abroad rose from $228 billion to $326 billion. From a direct investment gap of $124 billion in favor of the United States, we have shifted to a $3 billion gap in favor of foreign direct investment here, at least in the official numbers. This $127 billion change plus a net increase of $198 billion in foreign private holdings of non-government portfolio securities account for about half of the $670 billion net change in the total U.S. international investment position since 1981. In other words, our trade and current account deficits of the 1980s has been half paid for by the enticement of increased private foreign investment -- both direct and portfolio -- in the United States.

In these investments, foreigners assume the same risk as domestic investors should the U.S. economy falter or fail. And it is generally assumed that we cannot run trade and current account deficits of the present magnitude indefinitely. Thus, foreign corporate and private investors share our interest in turning around the trade deficit by increased U.S. exports, without domestic austerity and the long-feared "hard" landing.

Conclusion

To summarize my testimony, Mr. Chairman, I would like to make three major points.

-- First, NAM is opposed to any legislation which establishes discriminatory foreign investment reporting requirements, particularly if the confidentiality of proprietary corporate data is threatened.

-- Second, we are opposed to policies that threaten the ability of the United States to attract foreign equity investment in U.S. enterprises. We believe that such investment is the most productive way to fund the negative U.S. international financial position while we work to turn around the U.S. trade and current account deficits.

-- Finally, we continue to support policies aimed at continuing to open foreign markets for U.S. investment and trade.

Mr. GIBBONS [presiding]. Thank you for your very learned statement.

Let's go to Dr. Ture. We are very glad to have you here.

STATEMENT OF NORMAN B. TURE, PH.D., PRESIDENT, INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

Mr. TURE. The statement I am about to give represents views I have expressed in other forums. They are my own views. They are not necessarily those of my colleagues, board of directors, or contributors.

Mr. GIBBONS. I have listened to you for years. You have always given your own views.

Mr. TURE. EC–1992's economic integration efforts hold great promise for American business and the American economy, provided that U.S. public policy doesn't impose barriers to our businesses' investing and operating in the EC. We should be at pains to examine the foreign income provisions in our tax law in this light.

U.S. foreign tax provisions are protectionist. The underlying principle of these provisions is that American business investment and operations abroad should bear the same income tax costs as they would if undertaken in the United States.

Implementation of this "principle" says in effect that American businesses should not be able to take advantage of more favorable tax treatment that may be offered by a foreign government. This is comparable to saying that American businesses should not be able to take advantage of lower costs for any production inputs that may be available in other countries.

That, you will recognize, is exactly trade protectionism which is why I describe that situation like that.

Mr. GIBBONS. I had a lot of trouble convincing people of that.

Mr. TURE. Indeed. The validity of this "principle" rests on the assumption that American investment and operations abroad are at the expense of domestic investment production. This assumption is factually and conceptually incorrect.

A nonprotectionist foreign tax policy would be based on a true territoriality approach. The U.S. tax law would not seek to reach American companies' foreign operations at all, neither at the time these operations are undertaken nor when the earnings are repatriated.

As a practical matter, true territoriality is not a near-term goal of Federal tax policy. It should, however, serve as a guide for more limited statutory revisions aimed at moderating the protectionist thrust of the present law.

At the very least, this committee should make a determined effort to reduce the complexity of the present foreign income provisions. This complexity greatly increases compliance costs while still leaving many, if not most, multinational companies uncertain whether they are in compliance. Both the increase in compliance costs and the uncertainty increase the tax costs of investment and operations in other countries.

In many cases, the TRA86 changes in the foreign income provisions were made to close off so-called tax avoidance opportunities, hence to augment U.S. tax revenues from foreign operations of

American businesses or to accelerate the receipt of these tax revenues. It may well be that these changes have failed to generate incremental tax revenues sufficient to make up the revenues lost from the increase in deductible compliance costs.

If so, repeal of these provisions in the interest of simplification would enhance net tax revenues and reduce the tax cost of the foreign operations of American businesses and improve their competitive position in the world market.

A major candidate for revision should be subpart F. By accelerating payment of the U.S. tax, subpart F increases the effective tax rate on subpart F income. This income consists of return on the capital used by U.S. controlled foreign corporations. Increasingly, the effective tax rate on this income increases the cost of capital committed to the business activities that produce it.

At the very least, the committee should reexamine subpart F in the context of the opportunities and challenges posed by EC-1992. Although EC-1992 will treat all business activity in the EEC as occurring in a single market, subject to a single set of regulations and policies, our subpart F rules will continue to identify member countries as separate jurisdictions.

Under EC-1992, European companies will be able to incorporate and do business as Europe-wide businesses, free to choose the locations and the degree of integration of their various activities on the basis of real cost considerations, unaffected by tax differentials.

American companies, however, as you have heard from prior witnesses, will have to continue to take account of subpart F in their location and consolidation decisions, often forfeiting real cost savings as a result. At the least, subpart F should be revised to treat the EEC as a single country for purposes of its application.

The free flow of investment and business operations, unimpeded by tax considerations, across national borders is essential if American businesses are to be more effectively competitive in the world market. Our tax laws need to be revised to reduce the penalties they now impose on investing and operating abroad.

[The statement of Mr. Ture follows:]

EC92'S IMPLICATIONS FOR U.S. FOREIGN TAX POLICY

Testimony Presented to the
Committee on Ways and Means
U.S. House of Representatives
by
Norman B. Ture
Institute for Research on the Economics of Taxation
January 30, 1990

I am Norman B. Ture, president of the Institute for Research on the Economics of Taxation (IRET). I am grateful to the Committee for giving me the opportunity to testify on the implications of EC92 for American businesses' investment policies. This testimony presents views I have expressed on a number of occasions. These views are not necessarily those of IRET, its Board of Directors, or its contributors.

Introduction

The European Economic Community's efforts to achieve economic integration focus on removing institutional barriers to the flow of products, services, production inputs, and business enterprises among the member countries. To the extent these efforts succeed, the European economy can realize very substantial benefits from enhanced business efficiency. The very essence of EC92 is to enhance economic well being by removing artificial, government-imposed obstructions to efficient market performance.

These developments hold great promise for American businesses and for the American economy provided that (1) EC92 does not discriminate against businesses owned primarily by non-Europeans, and (2) U.S. public policies do not prevent American businesses from responding effectively to the opportunities EC92 will offer by perpetuating barriers or creating new ones to the movement of American business enterprises and capital across national boundaries. Regarding the first condition, the principal EC92 constraint appears to be that the advantages of integration will be available only to businesses that maintain a real operating presence in the European Community. Most American businesses that are eager to obtain these advantages have little, if any, problem with this requirement. More to the point is whether these businesses will be able to locate and operate business ventures in the European Community without confronting U.S. tax consequences that disadvantage them compared with foreign competitors. The real significance of EC92, I respectfully submit, is that it signals the urgency for an objective, careful, in-depth reappraisal of U.S. foreign tax policy.

EC92 should be seen as recognition by member countries of the obvious facts of life that all of us live in a global economy and that our economic well being depends critically on adjusting our domestic institutional arrangements to that reality. The notion of national origin of products and services has become antique. A great many of the products commonly purchased and used in the United States as in other nations travel back and forth among numerous national jurisdictions in their transformation from raw materials to finished goods. Efforts to determine national content of these products are as fruitless as they are pointless. Provisions of law or regulations that seek to deter American businesses from seeking out the lowest cost locations for producing components or for undertaking assembly operations and to confine such production activity to the United States are not only anti-competitive but unrealistic and costly as well.

Major features of U.S. foreign tax law are some of the principal barriers to efficient participation by American businesses in the world market place. The foreign tax provisions in the federal income tax law reflect a "fortress America" policy orientation. For the past several decades, the guiding objective of our foreign tax policy appears to have been to discourage foreign investment and business operations by American companies, based on the misapprehension that such activity occurs at the expense of investment, production, and employment here at home. The results of this long-standing policy have been to raise the cost of capital confronting American multinational businesses with respect to both their foreign and domestic operations, to disadvantage them in their foreign operations relative to foreign competitors, and to preclude their efficient location choices.

Recent changes in our foreign tax provisions, particularly those made by the Tax Reform Act of 1986, have exacerbated this protectionist complexion. The impetus for these changes appears to have been revenue gains. In fact, their principal consequence has been extraordinary increases in the complexity of the foreign tax provisions rather than additional tax revenues for the U.S. Treasury Department. In the name of greater equity, these provisions have befogged business decision making and introduced a host of artificial constraints on even the most basic considerations about what kinds of activities to undertake in what locations and with what resources.

I respectfully urge this Committee to give the highest priority to a searching and critical reappraisal of the present foreign tax provisions. In undertaking this assessment, the Committee should seek to eliminate those provisions of present law that increase, above the levels that would prevail in free markets, the costs American businesses must incur to invest and to operate in any location.

The Protectionist Character of U.S. Foreign Income Taxation

Federal income tax provisions pertaining to the tax treatment of income earned abroad by U.S. businesses are essentially protectionist in character. In essence, these provisions impose income tax on the income generated by American businesses in foreign jurisdictions in amounts at least equal to that imposed on an equal amount of income produced in the United States. If a foreign government imposes lower taxes on an American business' income generated in its jurisdiction than the U.S. would levy on the same amount of domestic income, the U.S. collects the difference. In other words, our tax overrides that of a foreign government if it imposes a lower tax on the income of an American business in its jurisdiction than we do.

The rationale offered by some economists for this system is that efficient allocation among all possible jurisdictions of the resources used by an American business requires that these resources produce per unit pre-tax earnings at least equal to those they would earn in the United States. The lower the amount of tax imposed on earnings, the lower the earnings need be to afford after-tax earnings sufficient to induce the resource owners to commit them to use in any particular location. Thus, if the tax imposed by a foreign government is less than that imposed by the United States on any given amount of earnings, it will pay the owners of the production inputs producing those earnings to commit them to use in the foreign jurisdiction even though their contribution to total output is greater here at home.

The fallacy in this argument is that the higher pre-tax return on the use of the resources here rather than in the lower tax jurisdiction reflects a higher cost imposed by the government on the use of those resources here compared to the foreign jurisdiction. In the face of that higher cost, fewer of those resources are used here, in combination with other production inputs, than would otherwise be the case. The smaller is the amount of such inputs used in combination with other production resources, the higher is their pre-tax returns. Indeed, sufficiently fewer of these resources are used here to afford pre-tax returns sufficiently great to cover the higher U.S. tax in order to assure that the after-tax reward for their use will be at least as great as in the lower-tax foreign jurisdiction. The obvious consequence is that we use less of the resources here at home than we would if our taxes were lighter; by the same token, we enjoy less of the output of these resources.

At the same time, our foreign tax provisions make sure that these resources can't be used more profitably in foreign jurisdictions. By insisting that taxes, foreign or U.S., must be imposed on the income produced by these resources used by American businesses in foreign jurisdictions at a rate no lower than the U.S. rate, we follow a dog-in-the-manger or beggar-my-neighbhor foreign tax policy. This is tax protectionism, precisely the same as trade protectionism.

Trade protectionism bases its case on the assumptions that (1) production abroad of products and services to be sold in the United States erodes our domestic employment, output, and income, and (2) production at home of products and services to be sold elsewhere expands domestic employment, output, and income. Tax protectionism rests on virtually identical assumptions: investment by American businesses in foreign ventures is at the expense of domestic investment, and the production by U.S. controlled foreign corporations is at the expense of production that would otherwise be undertaken in the domestic economy. Neither of these assumptions is correct, conceptually or factually.

The decision by a company to invest in facilities and to undertake business operations in a foreign location is impelled principally by two sets of considerations. One of these is the perception that penetration of foreign markets requires establishing an operating presence in those markets, even if most of the products and services to be sold in that market are produced in the United States. The second set of considerations are cost differentials, the determination that one or more production costs, including taxes, is sufficiently less in the foreign location than in the United States to afford the company higher profit margins and a greater return on investment that can be obtained here at home. The foreign production, therefore, is sold in both the U.S. and foreign markets at lower unit prices than those at which it could be sold with equal profitability if made here or in greater quantity at the prices that would be required for domestic production.

Note that these conditions and these results apply equally to a U.S.-owned and a foreign-owned company operating in the foreign location. No meaningful distinction can be drawn between the effects in the domestic economy of foreign investment and operations by U.S. multinationals and those of foreign-owned companies, whether the output of those operations flows into the U.S. domestic market or into foreign markets.

Are these effects injurious? As users or consumers of the foreign-produced products, Americans are clearly equally well served by a U.S. company or a foreign company producing the products in an advantageous foreign location. As producers of the products, the U.S. company and its owners are clearly better off in choosing the foreign location. The critical questions are (1) whether people who are not employed in the domestic economy by the company because the production occurs abroad are injured by the choice of the foreign site, and (2) whether the economy as a whole loses capital, its direct contribution to output, and its contribution to expanding productivity because investment is undertaken abroad?

To show that employees are injured, one would have to prove that they are completely specialized to the production of the products and services that are produced in the foreign location instead of here, so that if they are not employed producing those products, they can't be employed at all. One would also have to show that the U.S. company's foreign producer has a complete monopoly on the product so that no foreign-owned producer could take advantage of the economies available in the foreign location, produce the same products or close substitutes, and sell them in the domestic American market or foreign markets at lower prices than those at which the domestically-produced products would have to be sold. These conditions do not exist in the real world. The domestic employment consequences of foreign production, irrespective of who owns the foreign producer, are not losses of jobs but changes in jobs.

Participation in the world economy, by foreign investments of U.S. companies as well as by trade, often involves economic dislocations. Employees who lose jobs because competing products are produced abroad at lower costs must incur the costs of relocation. These private costs should not be treated lightly. To attempt to avert or moderate these costs by restricting imports or by insisting on domestic production of products aimed at domestic or foreign markets imposes much larger social costs. Public policy should be guided by the recognition of the social gains from efficiency-dictated location choices and should not sacrifice these gains by seeking to protect the employment status quo.

The notion that foreign investment is at the expense of domestic investment rests on the mistaken view that the aggregate amount of investment in any period of time is fixed. In this view, companies are bound to undertake the investment somewhere, irrespective of the rates of return on the investment. In this scheme of things, every dollar of capital added abroad is a dollar less capital added at home.

This view is at odds with reality. Every business continually confronts a threshold rate of return in its decisions about whether, how, and where to commit its resources. Any business that ignores that constraint soon finds that it can no longer acquire resources and may well wind up as a takeover target. A lower cost of capital in foreign jurisdictions is much likelier to increase a business's total investment than to shift its investment from domestic to foreign sites.

By the same token, increasing the cost of capital used in foreign locations doesn't, itself, reduce the cost of capital, here at home. U.S. tax provisions that raise the cost of capital confronting U.S. multinationals in their foreign operations don't induce these companies to increase the amount of their domestic investment; instead, they shrink the aggregate amount of capital formation.

The foreign tax provisions in the federal income tax raise the cost of capital confronting American-owned companies in many foreign jurisdictions, relative to the cost they would otherwise confront. This occurs whenever the U.S. tax provisions have the effect of increasing the present value of the aggregate tax liabilities on the results of these companies' foreign operations compared to the liabilities imposed by the foreign jurisdictions. The result is a lower amount and a less efficient allocation of investment by U.S. companies abroad compared to levels and uses that would otherwise prevail. Just as protectionist trade policies deprive us of the efficiency and welfare gains of unobstructed trade, so, too, do protectionist tax policies.

Our foreign tax provisions impose the same or higher tax costs on the foreign operations of U.S. companies as those they would incur if they conducted their foreign operations at home and, in many cases, higher tax costs than are imposed by the governments in the foreign locations. Trade protectionism, in a perfectly analogous fashion, seeks to impose on imported goods and services the same or higher prices as those of the same or comparable domestically-produced products and services. In both case, the most efficient use of production resources is impeded, and the well being of our citizens is eroded.

A truly non-protectionist tax policy would neither increase nor reduce the effective rate of tax imposed by a foreign government on the income generated by a U.S. multinational's operations in its jurisdiction. This criterion clearly calls for a true territorial approach under which U.S. tax law would not reach the results of U.S. companies' foreign operations, either at the time those results are realized or on the occasion of the repatriation of the foreign earnings.

As a practical matter, true territoriality is not a near-term goal of federal tax policy. It should serve, however, as a guide for more modest statutory revisions aimed at moderating the protectionist character of our tax system. If national policy is to recognize the exigencies of economic globalism, signaled by EC92, we need to reduce the barriers imposed by our present foreign tax provisions to effective participation by American businesses in the world market place.

Some Suggested Revisions

As the Committee is aware, the very nearly universal business complaint about the TRA86 revisions of the foreign tax provisions is the enormous complexity they added to the law. This added complexity greatly increases compliance costs. In doing so, it increases the tax costs of investment and operations in foreign jurisdictions.

One highly constructive effort the Committee might well undertake is simplification of the foreign tax provision changes made by the TRA86. In a great many cases, these changes were made ostensibly to close off so-called tax avoidance opportunities, hence to increase U.S. tax revenues from foreign operations of American businesses or to accelerate the receipt of these revenues. It may well be that these changes have failed to generate incremental tax revenues sufficient to offset the revenue losses from the increase in deductible compliance costs. If the Committee were to find this to be the case, repeal or further amendment of the TRA86 changes in the interest of simplification would not only enhance the net tax revenue flow to the Treasury; it would, even more importantly, reduce the tax cost of the foreign operations of American businesses and improve their competitive position in the world market.

Obvious candidates for the proposed review by the Committee are the provisions of present law that differentiate foreign tax credit treatment on the basis ~~of the~~ character of the income or the jurisdiction in which the income is realized. The numerous distinctions in the tax law with respect to kinds or sources of income and expense have no justification in economic logic. In particular, the distinction between so-called passive income and "other" income has no economic meaning. Source and allocation rules similarly defy economic logic and impose artificial constraints on business decision making.

Perhaps the most challenging set of provisions in the present law is Subpart F. It is difficult to understand the reasoning underlying rules that hold that if a controlled foreign corporation responds to the lower taxes imposed by a foreign government, it may not defer payment of the additional U.S.

income tax on its "Subpart F" income until that income is repatriated. By accelerating the U.S. tax payment, the effective rate of tax on Subpart F income is increased. This income, of course, consists of returns on the capital used by the controlled foreign corporation and affiliates. Increasing the effective tax rate on these returns increases the cost of capital committed to the business activities that produce them.

Subpart F is at odds with good tax policy both with respect to its singling out certain types of income for distinctive tax treatment and for subjecting that income to tax before its effective receipt by the U.S. person. The principles of territoriality that I suggested as guides to limited reform of our foreign tax provisions strongly urge a critical rethinking of Subpart F.

At the very least, the Committee should reexamine Subpart F in the context of the opportunities and challenges posed by EC92. At the very time that EC92 would treat all business activity in the EEC as occurring in a single market, our Subpart F rules continue to insist on identifying the member countries as separate economic jurisdictions. Under EC92, European companies presumably will be able to incorporate and do business as Europe-wide corporations. They will, accordingly, be free to choose the locations for their various activities on the basis of real cost considerations, unaffected by tax differentials. In contrast, U.S. companies' location and consolidation decisions will have to continue to be guided by concerns about Subpart F's treatment of undistributed earnings. Even barring repeal, at the very least Subpart F should be amended to treat the European Community as a single country for purposes of its application.

I am sure that many other witnesses, particularly those from the business community, have offered the same or similar suggestions. I hope the Committee will give careful consideration to these proposals.

Conclusion

Our foreign tax provisions have moved over the last several decades in a direction that is increasingly at odds with what has been happening in the real world. I hope that our public policy makers are sincere in their widely professed desire to allow American businesses to be more effectively competitive in the world market. If so, policy makers must recognize that the free flow of investment and business operations across national borders is essential to the realization of that objective. To this end, our tax laws need to be revised to reduce the penalties they now impose on investing and operating abroad.

Mr. Gibbons. Thank you, Doctor. I must admit I have been following the trade side of this Europe–1992 as closely as I could. I had just neglected or overlooked the tax side.

Are you all just becoming aware of 1992 as far as taxes are concerned? I had not heard from any of you on this issue. Is it a newly developing issue, the particular challenge of Europe-1992?

Mr. Ture. I and a lot of people with whom I have been working, Mr. Chairman, have been focusing for some time past on what I think is a basic fact of economic life of our times, that is, that the notion of a domestic economy is becoming less and less realistic.

The notion of a world economy is becoming more and more realistic. When you think about what a world economy entails, the thrust of the kind of tax law that we have which perceives the United States as sort of the only place in the world where economic activity ought to incur and perhaps by sufferage will allow it elsewhere is out of kilter with reality.

We ought not to be thinking of domestic market and production and activities. We ought to think of the entire world as being the scene where economic activity occurs. It would be to the advantage of our economy, of all the participants in our economy, if we so allocate our production resources as to maximize their product and that means making location choices based not on our tax law but on real economic considerations.

If we identify tax provisions that get in the way of doing that, we ought to reexamine that and make sure they serve a purpose that is sufficiently compelling to overwhelm these other considerations.

We have been looking at that situation before, I have to admit. EC–1992 looms large in our consciousness. It seems to me the way EC–1992 ought to be interpreted is as a signal saying here's a group of countries that have recognized something so obvious it is hard to understand how any one can fail to do so and they are adjusting their law and those institutions to those new facts of life. We ought to be concerned that we do the same.

Mr. Gibbons. Well, I am sure I will hear, "We can't do that because we will lose too much revenue to the United States." What is your answer to that?

Mr. Ture. That is a question that assails the members of this committee year in and year out. I don't dismiss it as a inconsequential question but it should get a response.

What is the cost of the lost revenue compared to the cost of the economic damage? Which should get priority in your deliberations? Should it be revenue flows or economic efficiency, progress and growth?

I think if you go to your constituents, any member, the answers will be clear. They are more interested in the goodness of their jobs, the security of their jobs, increase in the incomes at their jobs than they are in the revenue flows.

If the loss of revenues will help us to expand our economy and make it more efficient on the world scene, so be it.

Mr. Skovholt. In our company, our own people have been concerned about the subpart F issue. It may be that it is an evolving one. The opportunity to have these hearings has tended to coalese the issue and bring it to the surface. I think it has been an issue of growing concern.

Mr. **Gibbons**. You have both had excellent statements. I want to go back and read them. I know when we have this question up and I try to make some changes in the tax law, I am going to look out there and there will be a Treasury official, our joint committee revenue estimator and they will give me some huge figures.

About that time, the thing will fly out the door. I just hope there is some way we can do this without a great loss of revenue. I think it is important that American businesses be able to compete in Europe-1992 and the rest of the world, for that matter. But can it be done without a huge loss of revenue?

Mr. **Ture**. Let me see if I can answer that.

Suppose for a moment that the present subpart F provisions in the context of accomplished EC–1992 drives every American-controlled foreign corporation out of Europe. It will not produce anything. We are not going to get any revenues from subpart F. What we will have is a very sadly damaged U.S. economy and strong competitive advantages for all our competitors.

It seems to me that is the right way to ask that question without having to go to that. As you well know, revenue estimators both for your committee and in the Treasury Department do not generally take adequate account of the responses of people in the business community and the household community to changes in the tax law. The question demands that you do that, otherwise you cannot obtain a realistic assessment of what changes in the law will do.

You have to figure out what will happen under the kinds of circumstances I posited to the American businesses in that area under the circumstances I suggested.

Mr. **Gibbons**. Another subpart, I think the answer is real simple. They got subpart F, they just maintain those presences in all those countries, whether they are conducting or not, so there is no revenue change.

I think they can just stay where they are and then gradually become less competitive with that much overhead to carry. You say the tax laws of other foreign competitors such as Japan would make allowances such as you advocate.

Mr. **Ture**. I don't believe Japan has the equivalent of a subpart F.

Mr. **Gibbons**. Do they tax the income of their subsidiaries overseas?

Mr. **Ture**. Yes, they do. They do tax them on quite a different basis from the United States, and they are much more genial with respect to income generated in so-called tax haven countries than we are.

Mr. **Gibbons**. Well, how would an American concern and a Japanese concern compare, doing business in Europe after 1992? Who would have the advantage under the current tax laws?

Mr. **Ture**. Oh, I think there would be very little question about the fact that with respect to other subsidiaries——

Mr. **Gibbons**. And the Japanese law remains the same.

Mr. **Ture**. Yes. And that fiscal integration in the common market includes not merely value-added taxes and excises, but also the income tax structure I think the Japanese would have the edge.

Mr. **Gibbons**. Mr. Guarini.

Mr. **Guarini**. In other words, you believe that no matter what the cost is, no matter how great the revenue loss is, it is something that we have to do anyway. Is that your point, sir?

Mr. **Ture**. No. I think that sort of takes the point that I am offering to the hyperbolic——

Mr. **Guarini**. I mean, that is how I heard you that you've got to do it, don't even ask the question.

Mr. **Ture**. Let me qualify that. What I said in response to Mr. Gibbons' question was that one ought not to be guided merely by revenue considerations, that one ought to take account of what happens in the economy as well. It may very well be that the economic consequences are much, much more important than the changes in revenue flows.

Mr. **Guarini**. Well, when the GNP is less than 2 percent and the last quarter is one-half of 1 percent, and we may be in deep, deep trouble as far as slow down in our economy is concerned, would this be a good time then to consider this point?

Mr. **Ture**. Well, certainly this would not be a good time under those circumstances—to be thinking of any tax increases, and if the kind of tax changes that the witnesses appearing before you today have talked about would have the effect of increasing U.S. business activity around the world, that would be a plus, and I would——

Mr. **Guarini**. Long range, it would take time to manifest itself, but long range, I assume what you say is right. But now are you for taxing bonds or eliminating the withholding tax on bonds as was discussed by the earlier panel?

Mr. **Ture**. Well, if we have about five more hours, I think that could——

Mr. **Guarini**. Either you are for it or you are not for it.

Mr. **Ture**. I have a very qualified response to that, and to be able to explain it adequately to you, sir, I think it would take probably more time than you want to spend this afternoon.

Mr. **Guarini**. Do you have an opinion on that, sir?

Mr. **Skovholt**. I don't wish to——

Mr. **Guarini**. We do tax real estate. Should we tax one and not the other? Is that consistent as a logical deal?

Mr. **Ture**. Let me come back to the last question, because I will try to give you an answer in very short compass. Suppose we had here withholding, on the returns on bonds or any other such investments to foreign owners. Does that mean that the income that those bonds claim is tax exempt from the U.S. tax? That income is generated for the most part, almost without any exception, by corporate business.

That income will pay a corporate income tax, before distribution of dividends, interest, what have you, to, in this case, I think, perhaps mutual funds.

Mr. **Guarini**. If it is both by our corporations.

Mr. **Ture**. No, no, no.

Mr. **Guarini**. A lot of people buy American bonds overseas not expecting to pay tax to anybody.

Mr. **Ture**. What I am suggesting is that suppose a foreigner buys a share in a mutual fund. That mutual fund receives its income from U.S. operating companies, many of them domestic. Those companies are paying U.S. Federal income tax before they distribute any earnings to that mutual fund. It is not to say that those are tax free. It is to say that they are not taxed repeatedly.

Mr. **Guarini**. That is true about the provision that you spoke about, but on many of the billions of dollars of bonds that are being picked up by people overseas, it is not mutual funds, it is regular Treasury notes, Treasury bills, et cetera, where there is no withholding tax, where there used to be a 30-percent withholding tax and perhaps no taxes paid to any country on that, and we do that because we have to encourage money coming into the country. We are dependent on foreign money and it would raise our interest rates probably if we insisted on reporting the tax on these people.

Mr. **Ture**. I don't think that is the right way to look at it at all. Those foreign investors are going to make funds available to the U.S. Treasury. In the case that you gave, the U.S. Treasury will make use of those funds, but those foreign investors are not subject to U.S. tax law. It seems to be entirely unbecoming for us to try to impose our income tax on income that they obtained, no matter where they obtain it or how.

Mr. **Guarini**. Well, suppose if they bought real estate in New York and Los Angeles and they made rents and profits, would you feel the same thing about real estate as you do about bonds? One is an investment in the United States; one is a chattel; one is a piece of real estate.

Mr. **Ture**. Ordinarily the use of that real estate will produce income that is subject to law imposed here, subject to U.S. income tax.

Mr. **Guarini**. But is it logical to let one pay and the other doesn't pay? Double system of taxing your real estate and taxing your bonds and investments.

Mr. **Ture**. Well, but you are comparing apples and oranges. One flow is not a real income flow in the sense that it's a flow from income-producing assets.

Mr. **Guarini**. Absolutely. Real estate is rents and profits. What is the difference between that or 8 percent of a bond?

Mr. **Ture**. I am talking about Federal bonds. Federal bonds are not issued in order to be able to pay your resources, in order to buy real capital assets that produce income flows.

Mr. **Guarini**. All right. Thank you, sir.

Mr. **Gibbons**. As I recall, on that—before we took that withholding tax off, we didn't collect any tax on it anyway, nobody brought any money in.

Mr. **Guarini**. Beforehand, it was legally an obligation to withhold 30 percent.

Mr. **Gibbons**. Yes, but nobody—we didn't collect any of it.

Mr. **Guarini**. I think we did, sir.

Mr. **Gibbons**. No, we didn't either.

Mr. **Guarini**. Because it was a law that before it was sent overseas that the investment houses or whoever had it——

Mr. **Gibbons**. But nobody ever paid any tax.

Mr. **Guarini**. Well, I can imagine that there could be many Treasury notes and bills that were picked up overseas that we probably would have no way of getting jurisdiction over the people. But it was a requirement of law, and some taxes——

Mr. GIBBONS. Frank, we didn't collect any tax. I will tell you. Go ask the Treasury.

Mr. GUARINI. You know what is so inconsistent is that 10 years ago——

Mr. GIBBONS. Did we ever collect any tax?

Mr. TURE. I think the answer is precious little.

Mr. GUARINI. But 10 years ago, we had no capital tax on real estate if a person was a foreigner and didn't stay in the United States less than 6 months, but we got a 30-percent withholding tax on investments and bonds.

Now we just reverse it. We have no withholding tax on bonds, and we have a capital gains tax on real estate.

Mr. GIBBONS. Well, Frank——

Mr. GUARINI. It just seems like a 180-degree turnabout.

Mr. GIBBONS. It has to do with the panic of farmers who thought that their farmland was being controlled. They have been trying to get us to take it off so they could sell their farmland. That is the history of it.

Well, excuse us for getting into all that, and thank you very much for coming.

This concludes our hearings for today. We will convene again tomorrow morning at 9:30 in this room to be enlightened again.

[Whereupon, at 3 p.m., the committee adjourned, to reconvene at 9:30 a.m., Wednesday, January 31, 1990.]

U.S. TRADE RELATIONSHIPS WITH THE SOVIET UNION AND EASTERN EUROPE

WEDNESDAY, JANUARY 31, 1990

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met, pursuant to call, at 9:30 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. Good morning. The committee will come to order.

Today the Committee on Ways and Means concludes its hearings on U.S. trade relations with the Soviet Union and Eastern Europe. Our hearings yesterday were interesting and informative. I expect that our witnesses today will be equally expert in their views on the direction that U.S. trade relations with countries in this region should take in the future. Among our witnesses is one of the authors of the law governing our trade relations with nonmarket economy countries, Hon. Charles Vanik, a distinguished former member of this committee. We look forward to his testimony and to that of our other witnesses. The testimony we receive during these hearings will be helpful to the committee as it considers possible changes in United States trade policy toward the Soviet Union and Eastern European countries.

Our first witness today is Charles Hugel of the National Foreign Trade Council. He also is chairman and chief executive officer of ASEA Brown Boveri, Inc. Mr. Hugel, you may proceed. We look forward to your testimony.

STATEMENT OF CHARLES E. HUGEL, CHAIRMAN, NATIONAL FOREIGN TRADE COUNCIL, INC., AND CHAIRMAN, ASEA BROWN BOVERI INC., STAMFORD, CT

Mr. Hugel. Thank you and good morning. My name is Charles E. Hugel. I am testifying today on behalf of the National Foreign Trade Council, an association of more than 500 companies involved in international trade and investment. A significant number of our companies maintain a business presence in the Soviet Union. My written comments have been submitted previously.

My comments today will cover primarily the evolving economic relationship between the United States and the Soviet Union, particularly those measures which the United States Government should take to ensure that American companies are able to compete in the Soviet Union on an equal basis with other major trading nations. Although modest in the short term, the longer range potential of the Soviet market is likely to be substantial. Increased United States trade with the Soviets will also contribute to the integration of the Soviet Union into the world economy and help provide an economic basis for sustaining the reforms initiated by the Soviet Government.

We encourage the efforts of our Government on several fronts: to negotiate a trade agreement with the Soviet Union, followed by agreements on investment and taxation; to modify United States export control regulations; and to remove restrictions placed on the operations of the Export-Import Bank and the Overseas Private Investment Corporation. These actions will contribute substantially to the expansion of nonstrategic trade between our two countries.

These agreements are important because competition for access to Soviet markets is intense, and our major trade competitors are considerably ahead of us. The most recent, 1987, OECD trade figures illustrate this uncompetitive position, showing OECD exports to the U.S.S.R. at $21 billion, of which only $1.5 billion was from the United States. Of the $5.8 billion the Soviets spent on capital equipment and machinery in 1987, the United States share was only 2.3 percent.

Recognizing the seriousness of the situation, the NFTC has a number of specific recommendations for normalizing trade:

First, a bilateral U.S.-U.S.S.R. trade agreement. With liberalization of the Soviet Union's immigration practices and its movement to enact a new immigration law, we recommend a waiver of Jackson-Vanik for at least 3 years, to conform to the normal term of bilateral agreements and to overcome any potential Soviet partner's mistrust of swings in American policy. This will clear the way for MFN status, pursuant to a new United States-Soviet trade agreement. This agreement should cover not only the normal treaty elements, but also the practical market access problems faced by United States firms doing business in the U.S.S.R. Some examples are, the lack of hard currency and the inconvertibility of the ruble, the process of accreditation in the U.S.S.R., and the development of an adequate Soviet economic statistical base.

Second, the National Foreign Trade Council companies favor the early negotiation of a bilateral investment treaty. A satisfactory investment treaty will not be quickly negotiated since agreement on a number of critical elements will only follow certain fundamental changes in the Soviet system.

Third, United States business is at a disadvantage since our tax treaty with the Soviet Union was negotiated in 1973, long before the joint venture law and permits higher Soviet taxes than in their more recent treaties. Other tax problems need to be solved through a new tax treaty and by U.S. regulations or legislation.

Fourth, the United States is the only major Western government which does not provide financing for its exports into the U.S.S.R. As of September 1, 1987, there was $16 billion of official commitments from 15 Western countries to support exports to the U.S.S.R. The United States is listed at 3 percent of the total, just ahead of Portugal, dramatizing clearly the noncompetitiveness of United States business. The United States must move rapidly, following the waiver of Jackson-Vanik, to reestablish the Export-Import

Bank in the Soviet market and repeal other statutory restrictions on the bank such as the Stevenson and Byrd amendments.

Fifth, the United States should substantially revise the Export Administration Act prior to its expiration in September 1990 and lay aside proposals for a simple 1-year extension. The act should reflect a national priority on export expansion, as well as the need for American companies to compete on an equal basis with those of our major trading partners in the Soviet Union and elsewhere.

In concluding, let me emphasize that the measures and agreements I have cited in this testimony represent a formidable challenge for both governments, but they are the basic framework for expanding trade and normalizing economic relations between the two countries. We believe strongly that progress toward these goals will have enormous long-term benefits to both nations and to American business. It will, however, require a high level of commitment by the U.S. administration to negotiate the necessary agreements and to work with Congress to ensure their success.

Thank you.

[The prepared statement of Charles E. Hugel and an additional statement received subsequent to the hearings follow:]

REMARKS OF CHARLES E. HUGEL
CHAIRMAN, NATIONAL FOREIGN TRADE COUNCIL, INC.
BEFORE THE
WAYS AND MEANS COMMITTEE
U. S. HOUSE OF REPRESENTATIVES
WASHINGTON, D.C.
January 31, 1990

Mr. Chairman, Members of the Committee:

My name is Charles E. Hugel and I am Chairman of ASEA Brown Boveri Inc., as well as Chairman of the National Foreign Trade Council, on behalf of whom I am testifying today. The National Foreign Trade Council is an association of more than 500 companies involved in international trade and investment. A significant number of our companies maintain a business presence in the Soviet Union and others envision becoming active there.

Although you have outlined a broad range of very important issues to address in these hearings, I will restrict my comments to the evolving economic relationship between the United States and the Soviet Union, including those measures which the U.S. Government should take to insure that American companies are able to compete in the Soviet Union on an equal basis with other major trading nations. Although the commerical benefits of normalizing trade with the Soviet Union are likely to be modest in the short-term, the longer range potential of the Soviet market could be substantial. In addition to the potential of the Soviet Union as an important market, we are convinced that increased U.S. trade with the Soviets, as well as greater U.S. investment there, will contribute to the integration of the Soviet Union into the world economy and help to provide an economic basis for sustaining the reforms initiated by the Soviet government.

We applaud, therefore, the efforts of the Bush Administration to negotiate a trade agreement with the Soviet Union and to follow it with agreements on investment and taxation. We are also convinced that relaxation of U.S. export control regulations, and of restrictions placed on the operations of the Export-Import Bank and the Overseas Private Investment Corporation, will contribute substantially to the expansion of non-strategic trade between our two countries. These hearings begin the Congressional process which will be a prerequisite to the successful outcome of these undertakings.

Progress toward these agreements is especially important because competition for access to Soviet markets is intense, and our major trade competitors are considerably ahead of us. This trade lead derives from a complex of factors, including unique U.S. trade and credit restrictions and a substantial export control structure. Although the Soviet system itself poses an array of obstacles to trade, the longer and more reqular pattern of trade relationships our competitors have established with the U.S.S.R. gives them a significant lead in overcoming these obstacles. The most recent (1987) OECD trade figures illustrate our uncompetitive export position: the developed countries of the OECD had exports to the U.S.S.R. of $21 billion, of which only $1.5 billion was from the United States. Two thirds of these U.S. exports were agricultural products.

Our lack of competitiveness in the Soviet market, as well as our long-term export potential, is more clearly understood by looking at the U.S. share of important commodity groups the U.S.S.R. purchases from the OECD. The Soviets spent $5.8 billion on capital equipment and machinery in 1987. The U.S. share of this was only 2.3 percent. Of the commodity group including iron and steel-mill products, nonferrous metals, and glass, a $4.7 billion market in 1987, U.S. producers provided less than 1 percent of the total. Although not as dramatic, this pattern is repeated in other commodity groups and does not reflect the more competitive position these U.S. products enjoy in other markets. Economists from NFTC member companies estimate that if trade relations are normalized, U.S. exports to the U.S.S.R. could grow 5 to 10 times over the next decade.

A framework of understandings and formal agreements with the Soviet Union is of the greatest importance for U.S. business to position itself to compete in the Soviet Union. We therefore urge that the Administration move expeditiously to begin negotiations with the Soviets on as many of these matters as possible.

A. Trade Agreement

We are very encouraged that the Administration is proceeding with negotiations for a trade agreement, and is preparing ultimately to extend most-favored-nation status to the Soviet Union. Although extension of MFN status will not by itself dramatically increase trade between our two countries, it is fundamental to the process of normalization. Since the Soviet Union has liberalized its immigration practices and is moving to enact a new immigration law, we believe it would be appropriate for the President to waive the Jackson-Vanik provision enacted in 1974. However, the one-year waiver provision in the 1974 Act is inadequate for companies making business decisions for the longer-term. It is also a possible impediment from the point of view of Soviet business partners mistrustful of swings in American policy. We would, therefore, recommend amending the 1974 provision to provide for a three-year waiver, which is the normal term of bilateral trade agreements. Ultimately, if Soviet policy continues to move in its current favorable direction, we would strongly favor repeal of the Jackson-Vanik provision.

We do not believe that the starting point for the negotiation of a U.S.-Soviet trade agreement should be the agreement which was negotiated in 1973, nor do we believe that other recent trade agreements with non-market economies, such as our agreement with China, are adequate models. The trade agreement should address, to the maximum extent possible, the practical problems encountered by American companies in doing business in the Soviet Union. Not all of these problems can or should be dealt with explicitly in the agreement, but to facilitate commerce, appropriate commitments should be sought from the Soviet authorities. Examples of problems which our companies have encountered include:

(1) Inadequate hard currency availability
The lack of available hard currency in the U.S.S.R., with the ruble subject to strict currency controls and not freely convertible, is a significant barrier to the growth of U.S. trade and joint venture activity. Changes in the Soviet monetary structure will inevitably follow a long reform process within the Soviet economy, and one of the major problems for U.S. business - the direct repatriation of profits - can be fully resolved.

In the near term, a number of suggestions have been made regarding how profit repatriation and other convertibility related problems could be handled. The Soviets are currently discussing the establishment of Foreign Economic Zones which will provide special treatment for foreign companies investing in the U.S.S.R. Ideally this special treatment will include convertibility of ruble profits to hard currency. The Soviets have also begun a limited system of hard currency auctions. These are currently closed to foreign participation - including joint ventures - because they are in an early stage. We hope that over time foreigners will be able to at least buy rubles in these auctions and ultimately to buy hard currency as well. Trade consortia, wherein one U.S. member has the ability to earn foreign exchange to supply to other members, are also on the list of short-term remedies. Two other options might be considered.

First, in a trade agreement with the USSR, the U.S. government could seek a commitment from the Soviets to allocate a certain percentage of foreign exchange for direct purchase of U.S.

products. The amount of this allocation would depend on the balance of trade to be realized by the new MFN relationship. A formula could be developed whereby a percentage of the amount of new foreign exchange the Soviets earn in the U.S. market, as a result of their MFN status, would be dedicated to buying U.S. goods and services. This proposal goes beyond the tariff and quota changes granted with MFN to the larger market access opportunities associated with the new trade relationship.

The second proposal would involve an import substitution scheme. Under this plan, a U.S. partner in a joint venture could be given credit by the Soviet government for new products produced in the USSR for the internal market which displace products currently imported (into the USSR). There should be an official commitment to return to the joint venture the after tax profits earned on domestic sales therefore not requiring Soviet hard currency resources.

(2) Access to Soviet agencies with commerically important administrative jurisdiction

Doing business in the Soviet Union is hampered in two particular ways by the unique character of the Soviet system. The first is the size and inaccessiblity of it's bureaucracy. A second is the decentralization of Soviet ministries with whom American companies must deal and the need under the present arrangement for businesses to get clearances from multiple agencies at the federal level and to deal, as well, with republic authorities. This problem could be exacerbated if the leadership further devolves responsibility to republic authorities through perestroika and in response to demands for autonomy or independence. The Soviets should be strongly encouraged to set up a coordinating mechanism, ideally "one-stop-shopping", to deal with foreign companies. Even the process of establishing an office in the Soviet Union, a very important issue for companies headquartered at much greater distance from Moscow than the West Europeans, has been time-consuming and cumbersome. We hope, therefore, that the Administration will seek assurances that the Soviets will facilitate and expedite the process of approving accreditation in the USSR.

(3) Telecommunications

American companies require the ability to communcate easily and rapidly with their offices in the Soviet Union. The Soviet Union should, therefore, make a commitment to facilitate telephone, telex, and fax communications, as well as permit companies to set up their own means for communications, i.e. satellite dishes or similar independent capabilities.

(4) Financial Services

Foreign companies are not now able to establish ruble bank accounts in the Soviet Union. Since they need to make purchases within the Soviet Union, as well as to import from abroad, the Soviets should permit both ruble and foreign exchange bank accounts.

(5) Development of Adequate Soviet Economic Statistical Base

Although the Soviet government has begun to be more open about certain aspects of its economy, they still provide almost no information on either their convertible currency, trade, foreign assets and liabilities, or reserves. These and other economic and financial statistics are essential in day to day business relations, including credit decisions, risk analysis, etc. The trade agreement should specify the need for and the process by which prompt and energetic development of this important statistical base can be accomplished.

(6) Hiring and firing of local personnel

U.S. companies are restricted in their hiring of Soviet staff to using the state service organization. They should be permitted to hire from the general population and to dismiss unsatisfactory employees.

(7) Problems in acquiring space for offices, facilities and housing of personnel

The Soviets should be asked for assurances that facilities will be made available for normal business functioning. This would include a commitment to make space available for site development and devising a mutually acceptable arrangement for ownership of property. While we recognize that the Soviets have a shortage of suitable housing for their own needs, the U.S. should stress the importance to U.S. trade and investment of making adequate arrangements for housing U.S. company personnel.

B. Bilateral Investment Protection Agreement

We favor the early negotiation of a bilateral investment protection agreement with the Soviet Union to gain its commitment to recognized international norms for the treatment of foreign investment. This should be along the lines of the recent agreement reached between the Soviets and the Federal Republic of Germany. The nine bilateral investment treaties negotiated by the United States in 1987 provide a precedent but not a model. A treaty with the Soviets should include guaranteed access to foreign exchange for repatriation of profits, a guarantee of the right of establishment, a commitment to the principle of national treatment, protection from unlawful interference with property interests, an agreed dispute settlement mechanism, assured compensation in accordance with international law standards, and protection for intellectual and industrial property.

At the moment, and for the foreseeable future, joint ventures are the only vehicle for U.S. investment in the Soviet Union. The United States currently ranks third in the number of joint ventures completed with the Soviets, following West Germany and Finland respectively. Finland, West Germany, Belgium and Great Britain are among those countries that have completed investment protection agreements and treaties with the Soviet Union.

Soviet officials do seem to wish to create an environment conducive to joint venture investment and are considering significant legal revisions in banking, taxation, arbitration and other areas. We urge the Administration to encourage these developments and to incorporate commitments to them in the investment agreement.

Because in the short term, most-favored nation status will principally benefit the Soviets, it is important that the legal framework for investment, which is of direct benefit to American business, be expedited. This is because the major impediment to increased joint venture activity is risk exposure for U.S. companies. Legal and administrative barriers and ambiguities increase risk, and therefore increase the initial cost of investment.

We hope that legislative changes necessary to allow the availability of Overseas Private Investment Corporation (OPIC) programs in the Soviet Union will follow soon after the completion of bilateral trade and investment agreements. In the case of OPIC it is, of course, also necessary to remove congressionally imposed restrictions on insurance and guarantees.

C. Tax Matters

In order for U.S. exports to, and business in, the Soviet Union to thrive, it is important that Soviet taxation not act as a barrier. Yet, as compared to investors in the Soviet Union from other Western countries, American investors are overtaxed and face unnecessary uncertainty.

To put U.S. business on a sound competitive footing, three types of initiatives are required, two of which involve the U.S. Treasury Department. First, the current outdated income tax treaty with the Soviet Union should be renegotiated, and we urge the U.S. to take the initiative in this respect. Second, there are some domestic U.S. rules which may not be dealt with in the treaty which should be re-examined, particularly those related to the inconvertibility of and the multiple exchange rates for the ruble. Third, the Soviet Union should be encourage to clarify or modify its own tax rules, which so far are not well developed. While this is not the responsibility of the U.S., experience suggests that, as part of the tax treaty negotiation process, the exchange of ideas can be useful in encouraging the other party to undertake necessary actions.

With respect to the tax treaty, since the current U.S.-Soviet income tax treaty was enacted prior to the recent joint venture legislation with its attendant special tax regime, a number of important provisions are missing from the current treaty. For example, the treaty is silent as to the 20% dividend withholding tax imposed by the Soviets on distributions to foreign investors, whereas the recent Soviet treaties with the United Kingdom and other countries completely eliminate this withholding tax.

Also, it is important to use commonly understood language in defining what constitutes a taxable presence (permanent establishment) in the USSR. This language should specify that construction projects as well as building sites and installation and assembly projects do not constitute permanent establishments unless they last more than thirty-six months, with the possibility of a longer period in specific cases. This language is in the current Finland-USSR treaty. Along the same lines, standard language should be included that business profits may only be taxed if they are directly attributable to a permanent establishment. Finally, it should be made clear that income from services, including engineering services, are business profits for this purpose and, that if taxed in the USSR, this becomes income from foreign sources for purposes of the U.S. foreign tax credit.

There is a tax-related side to the inconvertible ruble. For example, how will the U.S. evaluate ruble profits and losses for U.S. tax purposes? U.S. companies may have to face the use of antiquated blocked income accounting rules under which related domestic expenses may become nondeductible so long as the joint venture's income is blocked. With respect to solving these issues, there is a choice: they could either be dealt with in the new tax treaty, or the U.S. could unilaterally elaborate its rules with respect to a nonconvertible currency and multiple exchange rates.

With respect to internal USSR tax law, it appears that there are several tax laws that can apply to a U.S. party doing business there. First, the Decree of May 12, 1978 creates a tax applicable to activities of foreigners on USSR territory and this appears to be enforced only haphazardly. This could give the impression that not all foreign taxpayers are treated equally and, as this decree does not apply to Soviet parties, that the Soviet playing field is not level for American companies. A separate set of rules applies to taxation of joint enterprises and yet another set applies to cooperatives, both leading to potential uncertainty. We are also concerned that the basis for determining the tax base is unclear and that the Soviet income tax of joint enterprises may not, in fact, be creditable for U.S. tax purposes, due to substantial differences between U.S. and USSR concepts of income. This could lead to double taxation of income related to investment or activities in the USSR. This issue could be dealt with by a new treaty.

In connection with the tax problems to which I have alluded, it is recognized that American companies are proceeding to explore opportunities in the Soviet Union. Frankly, we are concerned both about these tax issues and making deals before they are resolved in order not to lose out to the competition from other countries. In essence, we are proceeding on faith that the U.S. Government will soon renegotiate the income tax treaty and proceed to correct the tax problems which are not treaty issues. Accordingly, we would suggest that the Ways & Means Committee encourage Treasury to proceed to treaty negotiations soon, to address those problems which have an administrative solution, and to consider legislation where legislation is required.

Since this series of hearings also covers the taxation of foreign investment in the U.S., the National Foreign Trade Council is submitting a separate statement on that subject which urges (i) nondiscriminatory and reasonable levels of taxation so as to avoid a precedent for burdensome foreign taxation of U.S. multinationals; (ii) Congressional encouragement of the U.S. tax treaty program as the only means of securing reductions of foreign taxes to appropriate levels; and (iii) a fundamental re-examination of the U.S. taxation of international operations in light of EC 1992 and current mainstream economic thinking.

D. Export Credit Availability

A critical element in any strategy to liberalize trade with the U.S.S.R. and to immediately improve the competitive position of U.S. companies in the Soviet market is the removal of U.S. restrictions on government export credit and guarantee programs. Presently, the U.S. is the only major Western Government which does not provide financing for its exports into the U.S.S.R. The table below shows the level of official commitments of export support for trade with the Soviets and the disadvantage at which U.S. companies operate. These commitments totalled nearly $16 billion as of last fall, with the bulk of official credit support coming from our major overseas competitors. More than two thirds of officially supported exports, which amounts to more than $10.7 billion, come from Japan, Germany, France, and Italy.

OUTSTANDING OFFICIAL COMMITTMENTS FOR EXPORT SUPPORT TO USSR
BY MAJOR WESTERN GOVERNMENTS
(NOMINAL DOLLAR VALUE/MILLIONS)

COUNTRY	AMOUNT	% OF TOTAL
Austria	2090.4	13.2
Belgium	27.0	.2
Canada	78.3	.5
Denmark	233.7	1.5
Finland	718.9	4.6
France	2738.2	17.3
Germany	2941.0	18.6
Italy	1737.7	11.0
Japan	3309.4	21.0
Netherlands	257.8	1.6
Portugal	39.2	.2
Sweden	119.0	.8
Switzerland	293.0	1.9
U.K.	980.4	6.2
U.S.	47.4	.3
Other	168.8	1.1
TOTAL	15780.2	100.0

The U.S. businessman who needs financing for export sales into the USSR really has no place to go, since private export financing is generally unavailable. Most U.S. banks are not interested in doing business in the Soviet Union, as shown by the fact that the U.S. share of total commercial credits amounts to less than 3 percent of the $40 billion currently outstanding. Private lenders are not interested in financing U.S. exports without an Eximbank guarantee. Furthermore, the current trend within the Soviet Union for purchasing foreign products is toward official export credit support.

Countertrade and barter are not satisfactory substitutues for conventional forms of trade finance. They are not normally economic for either the U.S. seller or the Soviet buyer and they cannot match the competitive terms of official credits. In the context of disintegrating COMECOM arrangements, it is likely that the USSR will have increasingly less to contribute to countertrade transactions.

This lack of U.S. financing shows up in Soviet trade figures. In the structure of Soviet imports from OECD countries, technology-based capital intensive machinery is a dominant component. This group of products in fact involved $5.7 billion or 29 percent of total imports in 1987. U.S. capital equipment exports customarily require Export-Import Bank support. Without that support it is not hard to understand why our share of the Soviet capital goods market in 1987 was only 2.3 percent.

The principal impediment to Eximbank's providing guarantees and insurance in connection with exports to the Soviet Union is the Jackson-Vanik Amendment, the repeal of which has already been discussed. There are a number of other statutory restrictions on Eximbank which NFTC believes should be repealed.

Most important is the $300 million aggregate limit to Eximbank support that is part of the so-called Stevenson and Byrd Amendments. This $300 million is a total amount and is wholly inadequate if Eximbank is going to play a significant role in assisting American exporters (see table above). While we recognize one alternative would be to raise this ceiling, there is no justifiction for treating the Soviet Union differently from other countries where Eximbank is open for business. None of them have ceilings imposed by Congress, and neither should the Soviet Union.

Let me note a few other limitations which make little sense in today's world. The Stevenson Amendment prohibits financing for any production, processing or distribution of fossil fuel energy resources and imposes a $40 million limit (within the $300 million) for research or exploration of fossil fuel energy resources. In addition there is a Congressional reporting requirement for such financing of $25 million or more. The NFTC believes these restrictions bog down open, free trade and should be repealed.

Finally, a separate and specific presidential determination that it is in the national interest must be made for "loans" of $50 million or more. We believe this should be repealed since one overall presidential determination for the country is adequate and meets the so-called Marxist-Leninist country restrictions in Eximbank's Charter. In this era of openness we should find ways to again facilitate trade with the USSR by providing financing without the impediments noted above which were instituted in a different time.

E. U. S. Export Control Regulations

The Administration should urge Congress to substantially revise the Export Administration Act prior to its expiration in September 1990 and to lay aside proposals for a simple one-year extension. The Act should reflect a national priority on export expansion, as well as the need for American companies to compete on an equal basis with those of our major trading partners in the Soviet Union and elsewhere. The foreign availability provision in the Omnibus Trade Act of 1988 should be allowed to function as Congress intended and efforts to restrict its application, as proposed by some in the Congress, should be resisted. We believe that U.S. policy should aim at a license free zone for COCOM and 5 (k) countries, and that licensing requirements for exports to other countries should be significantly reduced.

The dramatic economic and political developments in the USSR and other Eastern European countries in the last year have significantly changed the nature of the military threat that our national security export controls are designed to address. Common sense dictates that COCOM, the multilateral Coordinating Committee on Export Controls based in Paris, should respond to the altered security situation by reassessing, as quickly as possible, the appropriateness of the current system of controls in terms of both the products controlled and the countries that are subject to controls.

Neither I nor the NFTC believe that there is no longer a need for any export controls. We believe quite strongly, however, that we are entering an era in which small technical adjustments in our export controls are no longer appropriate. If there is to be an ongoing COCOM consensus on the enforcement of those controls that are truly important, it will only be after COCOM rids itself of controls that are clearly anachronistic.

Conclusion

In concluding, let me emphasize that the measures and agreements I have cited in this testimony represent a formidable challenge for both governments, but they are the basic framework for expanding trade and normalizing economic relations between the two countries. We believe strongly that progress toward these goals will have enormous long-term benefits to both nations and to American business. It will, however, require a high level of commitment by the U.S. Administration to negotiate the necessary agreements and to work with Congress to ensure that extraneous policy concerns do not intrude in an unwarranted fashion.

Statement of the National Foreign Trade Council, Inc. Concerning the Taxation of Foreign Investment in the U.S. and U.S. Tax Legislation in Light of Europe 1992

Submitted to the
House Committee on Ways and Means
March 14, 1990

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The National Foreign Trade Council, Inc. (NFTC) is an association of approximately 500 U.S. business enterprises engaged in international trade and investment. The Chairman of the NFTC, Charles E. Hugel, testified before the Ways and Means Committee on January 31, 1990, on the economic relationship between the United States and the Soviet Union. This Statement addresses the two other issues being considered by the Ways and Means Committee at this series of hearings: the taxation of U.S. enterprises in light of Europe 1992, and the U.S. taxation of foreign investment in the U.S.

Rather than address these issues from the technical tax point of view, we would like to present a broader perspective at this time.

Taxation of U.S. Enterprises in Light of Europe 1992

Let me assure you that the NFTC and its members are well aware of the importance of Europe 1992. As presently constituted, the European Community is fast becoming a single market with a greater population than that of the U.S., with potential for further growth from Eastern Europe. Therefore, our members, and U.S. enterprise generally, are proceeding to improve their position within the Common Market.

As reported in The New York Times of February 8, 1990, "In the last six months of 1989, American companies led the world in snapping up companies in Europe . . . acquisitions by Americans, where prices were reported, totalled $15.2 billion, or 27.6% of the $50 billion total."

Such acquisitions or the establishment of foreign subsidiaries or branches are essential, as international competitiveness requires a local presence. However, once a local presence is established, tax issues are raised. This has two aspects. First, the taxes imposed by the foreign host countries, and second, the taxes imposed by the U.S.

With respect to taxes imposed by the foreign host countries, there are generally two levels of tax. There is the ordinary corporate tax which is imposed upon local corporations and branches or subsidiaries of U.S. and other foreign corporations. In addition, there is a withholding tax typically imposed upon the repatriation of earnings to the home country. In general, a withholding tax imposes a substantial additional burden on doing business in a European or other foreign country. In many cases, these withholding taxes are substantially reduced or eliminated by tax treaties and for that reason it is important that the U.S. Government continue an active tax treaty program so that it can secure reductions in withholding taxes from European and other foreign countries for the benefit of American multinationals investing in such countries. Treaties also provide other benefits to U.S. multinationals. They provide a threshold of taxation so that limited foreign activities do not attract foreign tax and they provide a Competent Authority mechanism so that there is a procedure available to avoid double taxation when two tax authorities seek to tax the same income. Therefore, we urge the House

Ways and Means Committee to help facilitate the treaty process, even though, under the Constitution, it does not have a direct participation in that process.

It should be emphasized that the statutory withholding tax rates imposed by the European countries establish a prohibitive level of taxation and that the effectiveness of U.S. enterprises in the European Community with the advent of Europe 1992 would be significantly limited if those withholding taxes remain unabated. Happily, under international norms, tax treaties reciprocally reduce withholding taxes on dividends, interest, and royalties, and for U.S. enterprise to remain competitive in Europe 1992, the U.S. must aggressively continue a tax treaty program, reducing withholding tax rates. This sort of tax reduction cannot be achieved by U.S. enterprise itself, but under international law and custom it is the role of the U.S. Government to negotiate on behalf of its corporate and other citizens. In other words, in addition to its role as the maker of tax policy and the domestic tax collector, the U.S. Treasury Department is the international tax representative of U.S. enterprise.

With respect to U.S. taxation, earnings distributed from foreign investments are subject to U.S. taxation the same as domestic earnings. Double taxation is avoided through a foreign tax credit.

While the conventional wisdom is that the foreign tax credit effectively avoids double taxation, in our view the Tax Reform Act of 1986 has made the foreign tax credit substantially less effective. A large part of this is caused by the detailed administrative rules which have been enacted in order to avoid potential "abuses" of the foreign tax credit. The rules have become so cumbersome that the administrative aspects of the foreign tax credit constitute a substantial burden for U.S. multinationals.

Beyond the administrative burden of the foreign tax credit, some of the substantive rules are unnecessarily harsh. For example, regardless of the amount of foreign tax paid, the Alternative Minimum Tax (AMT) enacted in 1986 provides that only 90% of the AMT can be offset by the foreign tax credit, providing a measure of double taxation. Further, the proliferation of foreign tax credit baskets is not only an administrative problem, but it unduly prevents the averaging of foreign taxes so that U.S. tax applies on foreign source income, even though, on the whole, foreign source income has borne tax equal to or greater than the U.S. taxation. Further, the interest and other expense allocation rules effectively deny U.S. tax deductions for U.S. costs.

The fundamental problem with harsh foreign tax credit rules is that they limit the international competitiveness of U.S. multinationals. While reductions in foreign withholding taxes and the securing of more effective foreign tax thresholds through the tax treaty system will help with foreign taxation, that is not sufficient and the U.S. taxes should be adjusted to assure the international competitiveness of U.S. multinationals.

It should also be noted that certain U.S. rules, such as the subpart F rules which tax the U.S. owners of controlled foreign corporations on certain types of undistributed income of such corporations, apply when certain transactions take place across national boundaries. Since, effectively, the European Community is becoming one economy, it would be useful if transactions within the European Community would be treated as single-country transactions.

U.S. Taxation of Direct Foreign Investment

We would also like to add our views about the U.S. taxation of foreign direct investment in the United States.

Our fundamental view is that the U.S. should tax foreign investment in the U.S. in a nondiscriminatory fashion and at levels consistent with international norms. Of course, foreign direct investment in the U.S. creates competition with which our membership has to contend, just as U.S. foreign direct investment creates competition in foreign countries, and we gladly accept the challenge at home and abroad. Such competition is good for all countries. In this respect, we agree with the testimony of Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System, before the Ways and Means Committee on January 25, 1990.

Further, as stated, in order for our members to compete outside of the United States they must establish a local presence and make foreign direct investments, and if the U.S. taxes foreign investments in the U.S. discriminatorily, or excessively, the inevitable result would be that U.S. multinationals would be subject to foreign discrimination and excessive foreign taxation, hurting the U.S. multinationals in the first instance, but ultimately hurting the U.S. economy generally.

In other words, protectionist U.S. taxation, ostensibly to protect U.S. industry or for any other reason, would come at the cost of discriminatory and excessive foreign taxation that would make it less possible for U.S. enterprises to compete outside of the U.S. In this regard, the U.S. has perhaps the most to lose. U.S. multinationals provide enormous numbers of jobs in the U.S. and also control a large share of foreign to foreign trade.

Because the factual circumstances of U.S. subsidiaries of foreign multinationals tend to be different than the factual circumstances of other U.S. corporations, certainly targeted U.S. tax legislation could well impose a discriminatory burden on foreign investment in the United States. In this connection, in 1989 the NFTC opposed two provisions which were enacted: the earnings stripping rules and the foreign recordkeeping and summons authority rules. Given that we are dealing with fresh legislation, enacted in compromise form, the NFTC does not intend to re-open these issues other than to suggest that in exercising its broad regulatory authority, the Treasury Department strive to the maximum extent possible to avoid practical discrimination.

We also note that there have been proposals to tax foreigners on capital gains on the disposition of stock in U.S. companies. Such a proposal has been considered by Congress on several occasions and, happily, has not been enacted. We would urge that such legislation be avoided in the future as inconsistent with international norms, potentially involving treaty override, and likely to result in U.S. companies paying a reciprocal type of tax to foreign countries.

We will now turn to tax treaties, focusing on foreign investment in the United States. As stated, U.S. multinationals depend on tax treaties to reduce excessive foreign withholding taxes and to avoid double taxation. As one would expect, tax treaties are reciprocal so that reductions in foreign withholding taxes are almost invariably matched by the same rates of U.S. withholding taxes. The U.S. reduction in its withholding taxes can be justified from several aspects. First, it is the cost of securing reductions in foreign taxes. Second, the U.S. 30% statutory withholding taxes are excessive exactions on gross income and are there to be reduced by treaty. Third, foreign investment in the U.S. is good for the U.S. economy. In fact, the U.S. economy is helped by both outbound and inbound investment, as investment based on economic conditions means international efficiency.

An important aspect of tax treaty policy applicable to foreign investment in the U.S. is the level of withholding tax imposed on dividends, interest, and royalties paid by a U.S. person to a foreign person. In some cases these payments are made by a U.S. subsidiary to foreign affiliates; in other cases, they are made by an unrelated U.S. corporation to foreign portfolio investors. The 1981 U.S. Model Treaty provides that the statutory withholding rates would be reduced on a reciprocal basis so that rates on dividends would be 5% on direct investment dividends, 15% on other dividends, and zero on interest and royalties. Also, it is noted that the Internal Revenue Code has a portfolio interest exemption under which interest paid to foreign portfolio investors is not subject to U.S. withholding tax if certain procedural requirements are met. With respect to the treaty reductions and exemptions, since those are provided on a reciprocal basis, the willingness of the U.S. to reduce its withholding tax to such levels is essential in order to have foreign countries similarly reduce their withholding taxes applicable to U.S. multinationals.

With respect to the portfolio exemption, that exemption enables U.S. multinationals to issue Eurobonds, effectively lowering the cost of financing. The practicality of the matter is that, while many Eurobond holders would be exempt from U.S. tax on a treaty basis, the international market for Eurobonds is such that a blanket exemption for the issue is the only way to benefit from the lower interest rates.

Much has been made of transfer pricing enforcement in the media. In principle, the NFTC accepts that the IRS can and should enforce U.S. transfer pricing regulations so that the U.S. tax base reflects arm's length dealings. But transfer pricing rules are not limited to the U.S. We would like to point out that the foreign countries in which our members do business are increasingly enforcing their own transfer pricing rules, seeking information and making adjustments. To the extent that the U.S. can avoid overreaching in seeking information and making any necessary adjustments in applying its transfer pricing rules in respect of foreign investment in the U.S., that will set a precedent for other countries to treat our members appropriately.

In that connection, one of the most successful aspects of international law is the mutual agreement article of income tax treaties which permits the "competent authorities" of the treaty countries to negotiate concerning inconsistent transfer pricing determinations (and on other matters) and to agree upon a single determination which avoids double taxation. In our view, avoiding double taxation is fundamental to appropriate international taxation, and we encourage the use of treaty provisions to avoid double taxation. In that connection, we note the provision for voluntary arbitration in the recently signed income tax treaty between the U.S. and Germany, and we urge that provision be ratified as part of that treaty and used where necessary so that there is a forum of last resort, assuring ultimate avoidance of double taxation. Further, we recommend a similar provision for inclusion in other U.S. treaties. It should be noted that the mutual agreement mechanism plays a major role in connection with U.S. investment abroad and is beginning to play a similar role in connection with foreign investment in the U.S.

One further comment with respect to treaties - the issue of treaties and legislation. While we understand that when Congress enacts new tax legislation it would like to see that legislation apply as soon as possible and universally, we do not believe it is appropriate to override the treaty obligations of the U.S. to accomplish that goal. Treaty overrides violate international law and constitute a departure from an agreement to which the U.S. is a party. Further, it induces other countries to ignore their treaty obligations, in one way or another, to the detriment of U.S. multinationals, and such instances appear to be multiplying. It becomes very difficult for the U.S. Treasury Department to effectively object to such action by other countries when the U.S., on its side, frequently overrides treaties. Nevertheless, we recognize that treaties need to be adjusted to conform to new tax legislation, but we believe that the treaty amending process is the appropriate methodology for that purpose.

Conclusion

In order to assure the competitiveness of U.S. enterprises in light of Europe 1992, the U.S. should give high priority to negotiating income tax treaties with low withholding tax rates, high thresholds, and effective mechanisms for mutual agreement in accordance with the U.S. Model and the new income tax treaty with Germany. Further, U.S. domestic legislation applicable to foreign income should be reviewed so that foreign tax credit becomes a more efficient and effective mechanism for avoiding double taxation, and the European Community is recognized as a single country.

With respect to foreign investment in the U.S., we welcome such competition just as we expect foreign countries to welcome the competition resulting from American investment abroad. In order to avoid excessive taxation of U.S. investment abroad, it is incumbent upon the U.S. to tax foreign investment in this country in a nondiscriminatory fashion and at levels commensurate with international norms. This needs to be accomplished through U.S. domestic legislation and through the tax treaty program. Since tax treaties are reciprocal, U.S. willingness to accept treaty provisions which are appropriate to foreign investment in the U.S. will directly inure to the benefit of U.S. enterprises.

Finally, given the importance of tax treaties to U.S. multinational enterprises, the U.S. should avoid treaty override, reflecting appropriate changes in tax policy through the treaty-amending process.

Chairman ROSTENKOWSKI. Thank you.

Mr. Hugel, have you been contacted by the administration at all with respect to your views? I understand the administration is going to try to package something for us.

I wondered whether they used you as a consultant in any way at all.

Mr. HUGEL. No; I have not been. I am speaking solely on behalf of the National Foreign Trade Council.

Chairman ROSTENKOWSKI. Mr. Gibbons.

Mr. GIBBONS. I guess the reason Mr. Rostenkowski asked that is that we are worried. We don't see the administration doing a lot. We have been handed a deadline in the form of a press release but we don't see any actual planning for this.

Mr. HUGEL. Of course over the last several years I have talked with the administration about my concerns about doing business with the Soviet Union. I believe the administration is starting to get its act together. They are starting to look with favor to improving relations with our two nations. But this is an urgent matter in my view as a businessman.

Chairman ROSTENKOWSKI. Will you yield?

Mr. GIBBONS. Surely.

Chairman ROSTENKOWSKI. This is one of the reasons why if those of us here who are going to try to frame legislation which the President suggests will be signed in June, I think there is going to have to be a great deal of deliberation in this area. It concerns us here as to whether or not people who are experts in the field are asked an opinion.

This governing by press release is what frightens us. Thank you for yielding, Mr. Gibbons.

[The following was subsequently received:]

NATIONAL FOREIGN TRADE COUNCIL, INC.
1625 K ST., N.W., WASHINGTON, D.C. 20006

FRANK D. KITTREDGE
PRESIDENT

February 2, 1990

Honorable Dan Rostenkowski
Chairman
House Ways and Means Committee
2111 Rayburn House Office Building
U.S. House of Representatives
Washington, DC 20515-1308

Dear Mr. Chairman:

At the hearings you held last Wednesday on the Soviet Union, you asked our Chairman, Charley Hugel, whether he had been consulted by the Administration, and he said that he had not. Which is true.

However, we have sent a considerable amount of information to them, including a direct letter to President Bush (November 28, 1989), outlining the business community's principal concerns relating to U.S.-Soviet trade and investment. Our USSR Working Group has also had continuing meetings with the Commerce Department, White House staff, USTR, State Department, Eximbank and OPIC, to bring them up to date on our companies' views and to gather information.

We have, nevertheless, been discouraged with the slow pace of the Administration's response. We will continue our direct interface with them and try to accelerate their activities. We will keep your staff informed and hope that your influence will convince the Administration to give this the proper attention it deserves.

With best regards,

Frank D. Kittredge

NATIONAL FOREIGN TRADE COUNCIL, INC.
1625 K STREET, N.W., WASHINGTON, DC 20006 (202) 887-0278

November 28, 1989

The President
The White House
Washington, D.C. 20500

Dear Mr. President:

I am writing to you on behalf of the National Foreign Trade Council, an association of more than 500 companies engaged in international trade and investment. A significant number of our member companies maintain a business presence in the Soviet Union and others envision becoming active there.

We support your efforts to improve U.S. relations with the Soviet Union, a crucial element of which is the expansion of non-strategic trade between our two countries. Trade is essential to our economic strength and is, therefore, linked to our national security. Given that business relations may be a subject of discussion in your upcoming meetings with President Gorbachev, I would like to convey to you some of the business community's principal concerns relating to U.S.-Soviet trade and investment.

We are concerned that without high-level governmental attention U.S. business may not be able to compete in the Soviet Union on an equal basis with other industrial nations. We, therefore, urge you to make it a high priority to begin negotiations on U.S.-Soviet trade and investment agreements. As part of this process, the Soviet Union should be encouraged to provide comprehensive financial and economic information and guarantees as a prerequisite to expanded capital flows. For our part, we must undertake a serious review of export control regulations to ensure that they reflect changing political and military realities. Finally, eventual Soviet participation in international financial institutions will be important to the development of our economic relations and we support negotiations toward that end.

I am enclosing a short paper detailing some of the issues of greatest concern to American companies. Rapid progress on these issues is not only important for the political relationship between the U.S. and the Soviet Union, it is critical if American companies are to remain competitive in an area of the world where our major trading partners are making significant efforts.

Respectfully yours,

Charles E. Hugel

Charles E. Hugel
Chairman

Enclosure

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RECOMMENDATIONS FOR EXPANDING U.S.-SOVIET ECONOMIC RELATIONS

The NFTC believes that it is in the best interest of the United States' national security to normalize trade relations between the U.S. and the U.S.S.R. on a reciprocal basis, ensuring access by American companies to the Soviet market for trade and investment.

Competition for access to Soviet markets is intense. In 1987, total OECD sales to the USSR were nearly $21 billion, of which only $1.5 billion came from the U.S., about two-thirds of which were agricultural products. The vast majority of industrial product sales were made by the Federal Republic of Germany and Japan. Futhermore, while the US provides no official financing of its exports to the USSR, the most recent figures from Eximbank indicate that total commitments from the other members of the OECD are approximately $16 billion, a figure likely to increase dramatically as competitor countries vie for this market.

Expanded trade with the Soviet Union should now be considered an integral part of our national security planning. NFTC recommedations for expanding US-Soviet trade are:

1. Waive Jackson-Vanik Restrictions

We welcome the prospect that the imminent codification by the Soviet legislature of new immigration regulations will be followed by a one-year waiver of the Jackson-Vanik amendment to the Trade Act of 1974. We recommend that the President ask the Congress to repeal the amendment by the end of the one-year waiver.

2. Extend MFN Status to the USSR

The President should ask the Congress to extend most-favored-nation status to the Soviet Union to take effect following the waiver of Jackson-Vanik. This will place trade with the Soviet Union on the same formal basis regarding tariffs as is trade with most other nations. This is a prerequisite for normalization of other aspects of U.S.-Soviet trade.

3. Negotiate New US-USSR Reciprocal Trade Agreement

Extension of most-favored-nation status to the Soviet Union must be part of a bilateral trade agreement. The US-USSR Joint Commercial Commission agreed to establish a working group to "begin considering, on an informal... basis, what issues would... be addressed in a bilateral trade agreement." While the NFTC strongly endorses the completion of a US-USSR trade agreement, we consider the tone and pace of the joint commission statement not sufficently ambitious. Many of the factors necessary for a successful trading relationship with the USSR depend on a timely and comprehensive trade agreement. Further, we urge the President to ask Congress to consider this new agreement under expedited procedures.

proposed by some in the Congress, should be resisted. We believe that U.S. policy should aim at a license free zone for COCOM and 5 (k) countries, with the Secretary of Commerce empowered to determine those individual countries that do not qualify for such treatment.

8. Provide Official U.S. Export Credits, Guarantees and Insurance

There is a growing need for offical financing of exports to the U.S.S.R. The Soviet preference for official credits and government guaranteed loans is seen in the increase in financing proposals by Japanese and European export credit agencies in support of exports to the U.S.S.R. To strengthen economic ties with the Soviets and effectively compete in their market, a number of steps must be taken in the short run. The U.S. must: 1) waive the Jackson-Vanik restrictions on financing of U.S.-Soviet trade in the Trade Act of 1984; and 2) as part of a larger legislative initiative, support modifications in the Byrd and Stevenson amendments to the Trade Act of 1974 and in section 2(b) (2) of the Export-Import Bank Act to facilitate official credit support for U.S. exports to the U.S.S.R. In the longer term (as mentioned in paragraph 10 below), substantial improvements in the disclosure of Soviet economic and financial data are essential if private lenders are to expand the base of financing available for trade with the U.S.S.R.

Because of the critical need for official financing, guarantees and insurance, the U.S. government should, where possible, adjust other financing programs to support U.S. trade and investment, especially the programs of the Overseas Private Investment Corporation, the Commodity Credit Corporation, and the Small Business Administration

9. Encourage Soviet Membership in the International Financial Institutions and an Eventual Relationship with the GATT

Normalization of economic relations with the Soviet Union will require their eventual participation in, and adherence to, the major institutions and agreements which form the basis of the international trading and financial systems.

Following granting of MFN status and negotiation of trade and investment agreements with the Soviet Union, the United States should offer advice to Soviet authorities about how to evolve the Soviet domestic economy and foreign trade regime in keeping with the market-oriented principles that underlie the General Agreement of Tariffs and Trade (GATT). Once it is clear that Soviet authorities are embarked in a direction compatible with the GATT, the U.S. should support a Soviet initiatve to gain observer status in the GATT. Negotiations toward any eventual membership in the GATT, however, should await clear moves toward a convertible ruble and a price-based economy. The U.S. should expect commitments and concessions from the Soviet Union in any negotiations similar to those made by other countries, such as Mexico, that have become Contracting Parties recently.

When the current debt default talks are favorably concluded and when the Soviet Union demonstrates its commitment to a convertible currency, the United States should support Soviet membership in the International Monetary Fund. Membership would undergird convertibility and assure the provision of comprehensive financial and economic information necessary for private trade and finance to take place and subject Soviet exchange rate policy to IMF surveillance.

10. Encourage Development of Adequate Soviet Economic Statistical Base

Although the Soviet government has begun to be more open about certain aspects of it's economy, they still provide almost no information on either their convertible currency, trade, foreign assets and liabilities, or reserves. These and other economic financial statistics are essential in day to day business relations, including credit decisions, risk analysis, etc. The US-USSR Joint Commercial Commission is planning a seminar on the "The Statistical Requirements for Modern Economy", and we urge the prompt and energetic development of this important statistical base.

11. Clarify Regulations Regarding USSR Natural Resources

A number of prospective JV participants are concerned about the availability and supply of raw materials as well as their pricing, transporation and distribution. Further, uncertainty exists as to possible ownership of fixed assets or even certain natural resources in the USSR. Clarification of these questions would be a further boost to U.S. investment or joint venture participation.

12. Clarify and Update Soviet Joint Venture Regulations

There is a continuing need for the Soviets to update their JV regulations to make the initiation and operation of joint ventures much clearer than is now the case. Such critical items as hard currency availability (see #4 above), a specific dispute resolution framework, and a recognition by the Soviets that some joint ventures would be for local markets only, should be incorporated in the regulations. Futhermore, the U.S. should encourage the Soviets' interest in establishing free enterprise zones in the USSR to enhance the success of joint ventures. The U.S. should press these points at the upcoming Joint Commission Seminar as well as offer to share our experience with the Soviets.

13. Improve Coordination between Ministries

The recognized complexities of operating between various Soviet ministries and between ministries and satellite factories should be taken in to account when implementing JV and other investment guidelines. The current requirement that all arrangements be negotiated independently with each Soviet ministry is cumbersome and inefficient, and often makes coordinated marketing and service strategies extremely difficult for U.S. exporters.

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4. Assure Hard Currency Availability

Until the ruble becomes fully convertible there is a strong need for some Soviet mechanism by which U.S. investors can be assured of the availability of hard currency in exchange for dividends or profits earned in rubles from joint ventures or investments. Furthermore, the ruble must be devalued to a realistic level. The availability of foreign exchange to repatriate earnings will not be easy, but the Soviet Union should at least grant foreign investors the right to foreign exchange credit to the extent that their production within the USSR displaces imports.

5. Negotiate US-USSR Tax Treaty

We are pleased that the Joint Commission has agreed that American and Soviet tax officials will meet at the earliest opportunity to negotiate a new tax treaty which would cover joint ventures and otherwise appropriately update the existing treaty. This is expecially important because when the existing tax treaty was signed in 1973, the Soviet Union had not yet enacted its joint venture law. Moreover, since that time, the Soviet Union has entered into more modern treaties with other countries which are better suited to facilitating appropriate trade and investment. In particular, we recommend that the new treaty similarly provide for no Soviet taxation on the distribution of joint venture profits, a broad interest exemption, a source country exemption for royalties and license fees, and a normal threshold requirement for taxation.

6. Negotiate Bilateral Investment Protection Agreement

We favor the early negotiation of a bilateral investment protection agreement with the Soviet Union to gain their commitment to recognized international norms for the treatment of foreign investment. This should be along the lines of the recent agreement reached between the Soviets and the Federal Republic of Germany. The nine bilateral investment treaties negotiated by the United States in 1987 provide a precedent and in many ways a model. A treaty with the Soviets should include guaranteed access to foreign exchange for repatriation of profits, a commitment to the principle of national treatment, protection from unlawful interference with property interests, an agreed dispute settlement mechanism, and assured compensation in accordance with international law standards.

7. Review U.S. Export Controls

The Administration should urge Congress to substantially revise the Export Administration Act prior to its expiration in September 1990, and lay aside proposals for a simple one-year extension. That Act should reflect a national priority on export expansion, as well as the need for American companies to compete on an equal basis with those of our major trading partners in the Soviet Union and elswhere. The foreign availability provision in the Omnibus Trade Act of 1988 should be allowed to function as Congress intended and efforts to restrict its application, as

Mr. **Gibbons**. Press releases is our department. They have to do some work down there.

I notice you have mentioned a 3-year waiver and then you say it would be better to repeal Jackson-Vanik. A number of witnesses said that yesterday and I want to talk about that issue for a second.

The two high-technology businesses that seemed to have penetrated Russia so far are Pizza Hut and McDonald's. I saw them on television this morning—McDonald's opening in Moscow. But yesterday Mr. Kendall, CEO of Pizza Hut and Pepsi, said it took 12 to 14 years of negotiation to get in there. Now what is a 3-year waiver going to do for the American business person trying to get in there? I know that the bureaucracy is something else over there.

It is not tortuous as far as the paperwork is concerned and its deliberation is concerned. I just worry about a 3-year waiver or any kind of short waiver. We can always reenact these laws if we have to. What is your view?

Mr. **Hugel**. I share your concern. I believe the bill should be repealed, repealed now.

I signed the first United States joint venture with the Soviet Union and have signed four others since. One of them is a $2 billion joint venture to construct petrochemical plants in western Siberia. We are actively engaged in initiating the engineering on that program now.

I think I know how to negotiate with the Soviet Union. I know the obstacles. I can tell you, we need more freedom to work with the Soviet Union. It is an enormous market for the United States. They have natural resources that I believe they want to share with the United States. We should take advantage of that. They have the world's largest gas reserves They are the largest producer of petroleum, and we are running out of petroleum.

The Byrd amendment restricts our ability to deal with the Soviet Union on energy. That just doesn't make sense in 1990. You are quite right, those people who asked for 1 or 1½ or 2 years' waiver of the Jackson-Vanik, you cannot do it in that period of time. It should be repealed.

Mr. **Gibbons**. I think the Russians made the mistake Castro did not make—they did not let their dissidents out. And the dissidents brought them down. We are all going to claim credit for the great victory over communism, but the victory belongs to an idea that was invented a long time ago—freedom. The Russians got sight of it from satellite television or from somebody and you cannot resist it once you are tempted.

That is what has them. All the things that the Soviet Government has done have not stamped out the desire for freedom and the personal exhilaration people get from freedom. You can see it in Czechoslovakia. People walk straighter; they have smiles on their faces. I have been there many times before and after freedom. It is remarkable.

Chairman **Rostenkowski**. Thank you, Mr. Gibbons. Do any members care to inquire? Mrs. Kennelly.

Mrs. **Kennelly**. Thank you.

I would like to welcome Mr. Hugel to the committee. He is testifying as an expert on international affairs, but I know him as a member of the Connecticut community.

Mr. Hugel, I know you are testifying with relation to the Soviet Union and prospective trade agreements. Would you comment on whether you think the same approach—most favored nation—should be extended to the other four countries—Bulgaria, Czechoslovakia, Romania, and East Germany—or is a different approach in order?

Mr. HUGEL. I think you can draw a distinction between the Soviet Union and other Eastern bloc countries in this regard. Most Eastern bloc countries have a history of industrialization, market society, and some freedom. The Soviet Union has never had that. They did not have it under the Communists or under the czars. They don't have the infrastructure to have the kind of market economy that they want to have and we would like to see them have. That has to be built.

So I think that it is more urgent to move aggressively in these matters with the Soviet Union. I am not implying that we should ignore the others but they are quite distinct in my view.

Mrs. KENNELLY. But you would not object to us giving most favored nation to these other countries in the Eastern bloc?

Mr. HUGEL. Absolutely not.

Mrs. KENNELLY. Thank you.

Chairman ROSTENKOWSKI. Thank you, Mr. Hugel. Thank you for joining us.

Mr. HUGEL. Thank you.

Chairman ROSTENKOWSKI. Mr. Atkins.

Mr. ATKINS. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Welcome to the committee, Mr. Atkins. It is always a pleasure to have a colleague testify before the Committee on Ways and Means. I am sure we will be most enlightened by your testimony. You may proceed.

STATEMENT OF HON. CHESTER G. ATKINS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS

Mr. ATKINS. Mr. Chairman, thank you for providing me with this opportunity to address the committee.

Change in Eastern Europe has been so dramatic and has occurred so quickly that it is easy to be caught up in the rush to respond to the nations of Eastern Europe as a whole, or as if their situations were identical. In the past, this committee has wisely set a precedent of evaluating trade relations with other nations on a case-by-case basis.

I visited Romania for 6 days, shortly after the revolution, and I retained some very strong, very lasting impressions.

In reflecting on those experiences and the events of the past 2 weeks, I must confess I am faced with a dilemma. On the one hand, the Romanian people have made tremendous strides in the month since they toppled the Ceausescu regime. They have come so far in so short a time, and it is essential that the United States be generous in expressing its support for the reforms that have already been achieved. Yet on the other hand, any recognition of what has been achieved thus far must be presented in a manner that encourages additional lasting reforms.

In considering granting most-favored-nation status and recommending waivers of Jackson-Vanik for Romania, it appears the President is faced with the same dilemma. Granting most-favored-nation status is the most obvious and least expensive way to acknowledge the achievements of the people of Romania, but there are still important questions regarding basic human rights and religious liberties that must be clearly answered.

I believe that Congress and this committee can send a very valuable message to both the President and the new Government of Romania: America cares about human rights, religious freedom, and democratic principles. That message must be clear. We hope that Romania will embrace these principles, and not craft simplistic reforms solely to satisfy the narrowest reading of Jackson-Vanik. The Congress has historically done a great service by holding nations up to sharper scrutiny than Jackson-Vanik requires.

Granting MFN has an impact far greater in scope than the simple economic benefits. It symbolizes acceptance of the current Government by the U.S. Government, and confers legitimacy on national leaders. Romania must understand that we want to grant MFN status, and that we are eager to support its young democracy however we can. Still, it must be clear that MFN is not automatic, and the substance of democracy must accompany the trappings. The promise of free and fair elections with full participation of opposition parties is not enough. Those elections must become a reality.

There is growing frustration with the lack of response to the situation in Romania on the part of the United States. The Romanians I met with asked the same questions you have seen in headlines of the Washington Post: "Where are the Americans?" There are several actions that the United States can take immediately, exclusive of most-favored-nation status, to assist the Romanian people in their struggle for democracy.

We ought to take those actions, sending a high-level United States delegation, trade missions, legal scholars, medical experts, et cetera, but not use MFN, which is really our most important tool, before we have a clear sense of the direction of the Romanian Government.

We can provide legal scholars who could share their expertise with the Romanians as they try to craft both an election law and a constitution. With no tradition of free press, Romanian journalists are casting about for the most effective ways to cover events as they unfold, and are desperate for training in the coverage of political campaigns. And on an even more basic level, we can provide technical assistance to Romanian hospitals, where desperately needed medical equipment lies idle, waiting for spare parts and people with the training to make repairs.

I understand that these actions do not fall within the purview of this committee, but in light of our country's inaction it is important to bring them to the fore and perhaps generate some positive response. The situation in Romania is troubling. There are not yet permanent guarantees that human rights, democratic principles, and religious liberties will be safeguarded.

The National Salvation Front has recently taken actions that have raised serious questions among opposition groups about the likelihood of free and fair elections. I hope that the President takes these factors under consideration before he initiates action on Romania's MFN status, and that this committee continues to view its mandate broadly and provide a forum for discussion of human rights issues as we chart the course of United States trade policy with Romania.

Therefore, I hope this committee sets the stage for most-favored-nation status and at the same time alerts the Romanian people that it is our wish to provide the benefits of MFN. Still, we should take full advantage of the lengthy notification and consideration process built into the Jackson-Vanik procedures so that MFN is granted after the May elections and after we have some assurances that democratic principles and basic human freedoms are valued.

Thank you again for the opportunity to share my views, Mr. Chairman.

Chairman ROSTENKOWSKI. Thank you, Mr. Atkins. Thank you for joining us. Mr. Cardin.

Mr. CARDIN. I want to compliment my colleague for his testimony here. We have heard a lot of witnesses who have been very strong in support of either the waiver or repeal of Jackson-Vanik.

Look at the very narrow issue of the U.S. trade position with these countries. I very much appreciate your testimony which speaks to a role the United States has played in the world in leadership on human rights status. The granting of the MFN is broader than the narrow purpose of the statute. You deal with Romania in your testimony but expanding that to the Soviet Union, in considering action that we take with regard to Jackson-Vanik, we are really dealing with issues that go beyond just the trade issue and that we need to take that into consideration as we deliberate changes.

I take it you would be opposed to the repeal of Jackson-Vanik, that you think it continues to serve a useful purpose as it relates to the U.S. agenda in the world leadership on human rights.

Mr. ATKINS. I will limit my remarks to the instance of Romania where I have some knowledge, where Jackson-Vanik plays an important role. It would be most unfortunate if, in the case of Romania, Jackson-Vanik were repealed outright.

Also having spoken with a number of leaders and people in the opposition and in the Government of Romania, I appreciate the enormous role this committee played in your actions in repealing MFN under the Ceausescu regime. Even though that regime resigned MFN themselves or repudiated it, they did it only because they knew that this committee and the Congress were going to do it for them and they did not want to have the insult of that.

After my considerations with a variety of people, I would say that action played an enormous role in creating the circumstances which made the Romanian revolution possible. I think that the decision that this committee makes on when it grants MFN is going to play an enormous role in terms of the direction of the Romania democracy.

So it is an important issue. I hope that it is not guided by commercial pressures but rather by looking at the enormous implications and the enormous symbolic power you hold when you grant MFN. I hope this committee will continue to consider each nation separately and hold people up to a higher scrutiny than Jackson-Vanik requires.

Mr. CARDIN. I concur. Thank you.

Chairman ROSTENKOWSKI. Mrs. Kennelly.

Mrs. KENNELLY. Mr. Atkins, I would like to commend you. During our last break, many Members of the House and Senate took factfinding trips to Eastern Europe, wanting very much to share in the euphoria of the change that we have been watching.

I commend you as, I think, one of two Members of Congress that went to Romania. We obviously know things there are not quite as normal as they are, say, in Czechoslovakia. I would like to play the devil's advocate with you.

We just had a gentleman with tremendous expertise who urges us to move rapidly to do things for these countries. Yesterday we heard that Japan and Italy are there, in Eastern Europe. We are not quite at the table as our business people feel we should be.

Yet you say we should not give the MFN to Romania until after the election. Would you say that for Czechoslovakia or the Soviet Union.

Mr. ATKINS. I would have to say to the gentlelady from Connecticut who has been so involved in these issues, that I don't have the expertise or the firsthand experience to suggest the course that we should take in the Soviet Union or in Czechoslovakia.

I would endorse the process of the committee in the past. I know there is a tremendous temptation to view the Soviet Union and Eastern Europe all as one bloc. I suggest the conditions in each of those countries are dramatically different.

I hope your consideration will be on a nation-by-nation basis. I also hope that the committee avoid the temptation to say because we are doing nothing else, MFN is the cheapest thing to do. The United States and Romania only provided I think $700,000 in emergency medical supplies. Rather than get us involved in Romania, that would take us out of the equation.

I think it would be an enormous blow to those people who are looking to press for true democratic reforms in the country and it would be a premature signal that would be sent by this committee. I think the things that need to be done are more humanitarian gestures, medical supplies, sending experts over, the National Endowment for Democracy. We ought not to use MFN as a shortcut to avoid having to deal with those issues.

Mrs. KENNELLY. I hear you, Mr. Atkins, but I continue to want to play the devil's advocate about this. Yesterday, the businessmen we heard from who have done business in Communist countries before the revolution made it very clear to us that MFN is a psychological boost.

It does not have the impetus it had in 1970. It is a message that we want to do business. The testimony is very revealing that Romania, having had this at one time, they were remarkably successful in its use, although they were as evil as any government could be. I hope you don't single out this country which is really down and out and probably suffering worse than any other country we are talking about, and not heighten the stakes for them. Give them the psychological boost and set up goals for them.

We are getting back into the issue that we are having the hearings to discuss. I caution you as I caution myself that we need to tread very carefully.

Mr. **Atkins**. I think your caution is very well placed. Certainly the situation in Romania is desperate and certainly one of the first things we want to do is encourage cooperation, Occidental Petroleum for example was the one in Romania previously, and you encourage those relations.

But I think how we do it and when we do it, the important signal that this committee can send is to send a signal that we are prepared to move on MFN, that we are reviewing the conditions and we are moving with an eye toward wanting to do it. But at the same time, we should hold back from the final step of actually granting MFN, to wait and see the precise direction of the revolution. Right now there are enormous forces, still substantial Stalinist forces within the Government who would like to see a continuation of a one-party state, who do not want to grant the kinds of liberties that I think all of us and a vast majority of the Romanian people would like granted.

I think it would be most unfortunate to send the wrong signal at this time which would strengthen the hand of those people who want to pursue a more Stalinist course.

Mrs. **Kennelly**. I hear you, Mr. Atkins, yet we have not yet had the revolution in the Soviet Union. I think we have to be very careful in our attempt to set up goals.

Chairman **Rostenkowski**. Mr. Gibbons.

Mr. **Gibbons**. Mr. Atkins, you impress me as being a very fine and very fair and very nice person.

Mr. **Atkins**. I appreciate that but I have a sense I know what is coming.

Mr. **Gibbons**. I don't know whether you missed my former monolog about freedom.

We had a witness yesterday, a fine person, who said a lot of people possess a World War II mentality. At the end of that war, we had a monopoly on goods and services and technology and we could pretty much dictate to people what they would do. Therefore, we could lead with a stick.

Today, our stick has turned into a twig. We don't have a monopoly on goods and services. Now all of our allies and our friends are going to be in Romania and they are going to be doing business. They are going to be there without a lot of high-sounding ideas.

But the Romanians will catch from them the spirit of freedom, what it means to cooperate, move and talk freely, not have secret police, and things like that.

I think we can add to that. We have the freest society on Earth. I think we ought to lead by example, not with a stick. I would like to believe the decisions we make here will affect what happens in Romania.

But truthfully we will have to compete with their ideas and our ideas, our equipment and their equipment. We don't have the

World War II monopoly anymore. That is where I stand. I respect your views but experience has taught me that things have changed.

Mr. ATKINS. If I might respond to that, I certainly have enormous respect for your experience on the trade experience and for a substantial period of time on so many other issues. I suggest we should not view MFN as a trick.

Mr. GIBBONS. That is all it is. What is the difference between Smoot-Hawley tariffs and modern tariffs. That is all the law is.

Mr. ATKINS. I would suggest that the situation for MFN in Romania is very different from anyplace else in the world.

I think one of the things we ought to do is appreciate the enormous role that this committee has had in the past in terms of direction of the Romanian Government.

Frankly, previous administrations granted MFN to Romania. The importance was not the importance of the trade relationship that was established. The importance was that granting of MFN status was in essence a Good Housekeeping seal of approval from the United States to the Ceausescu regime.

Mr. GIBBONS. No, it was not. May I comment on that. Nobody argued more with Ceausescu than I did. I argued with him about religion, freedom, his secret police, et cetera.

What happened was some businessmen got there and the virus of freedom caught hold. It was not what we said or did here. Some writers may say that but I was there.

Mr. ATKINS. I appreciate that and I appreciate your strong advocacy and your history on this issue.

From my conversations with a number of people, dissidents and people in the Government, what they indicated to me and I am just reflecting their view of the situation, in their view the granting of MFN status would have an enormous symbolic value; that the removal and it was very clear when they rejected MFN, the actions by the Congress had a very clear symbolic value.

We are talking here really a very short timeframe, a difference of a couple of months.

Mr. GIBBONS. Don't worry about that. We won't even get legislation from the administration prior to that time. You are worrying about something that is not real.

Mr. ATKINS. My belief is that there are significant pressures on the administration to start the process immediately. I think we may be talking just a few weeks, if that, in difference between us, and it is important that our granting of MFN not be used as something that will hinder those forces in Romania who want a greater democracy and freedom. That is my only point.

I certainly think that we ought to grant it and grant it quickly but just after the elections, not before.

Mr. GIBBONS. I will guarantee you, we will not do it before the elections. They just decided down at the White House who is going to do the negotiating on the thing. They have not even started.

Chairman ROSTENKOWSKI. Mr. Guarini.

Mr. GUARINI. Chet, thank you for coming. I was also in Eastern Europe, but not in Romania. There was a tremendous spirit of free enterprise in the marketplace. There were people from all parts of the world there to look at investments. I went to five countries. The Japanese and West Germans are moving.

Business is going forward at a lightning pace. We are competitive with all the other countries and if we sat on the high ground, let all the other people make these deals, and give nothing to our businessmen with permanency—where they can make long range plans for investments—we are going to diminish our presence there. I think time is critical. The legislative process might be very glacial in how it moves forward and maybe we cannot achieve what we want at an early date. But I suggest that we move as quickly as we can to give certainty and permanency to the business people who want to make investments and be very competitive. In that way we will serve the cause of the revolution much quicker than if we move at a slow, cautious pace and let all the other countries vest their interests before we even start talking about it.

I would opt to start being competitive with the other countries that are moving forward and give certainty and permanency to the business people who want to invest in that part of the world.

Mr. ATKINS. I think that is an important point. We are not talking about a matter more than weeks or a month at most in terms of granting it after the elections rather than before.

The situation in Romania is quite different from what it is in Czechoslovakia. There is an economic system that is totally centralized. There is not one piece of private enterprise. The agricultural system is virtually all collectivized.

Mr. GUARINI. I know each country is very different from the others.

Mr. ATKINS. I think it is important to send a signal to our business community, and indeed we are in there, way behind the other countries, but that signal can be sent by sending a high-level delegation of business people and sending the signal that we are moving toward MFN. What I fear that because we are unwilling to send the Commerce Secretary, unwilling to send a high level delegation that the signal we send instead is immediate and fast-track lifting of MFN. I think that will have a significant adverse effect on the people who are pushing for more freedom and a free market economy in the long run and would serve our business interests poorly.

In Czechoslovakia and places like that there are immediate business opportunities. In Romania it is going to take some period of time for there to be business opportunities and an ability in the bureaucracy for people to relate to a foreign business coming in and wanting to set up some activity.

Chairman ROSTENKOWSKI. I am happy now to welcome a former colleague with whom I served with great pleasure. Charlie, it is a pleasure to have you here. You are going to bring back a familiar fragrance of concern and happiness.

I love seeing you. You look great. I hope Effie is okay.

Mr. VANIK. Effie is fine.

Chairman ROSTENKOWSKI. I know those members who did not serve when you were here missed something.

Mr. GIBBONS. I cannot top you, Mr. Chairman, but I will tell you, Charlie, the place is a lot cleaner since you left. He used to bring all his junk mail to the committee and he used to write all the time. You would never think Charlie was paying attention to anything but he never missed a word. He analyzed the problems real well.

Chairman **Rostenkowski**. I think one of his greatest contributions in interrogating a witness was when he asked, "Do you mean to tell me?"

Mr. **Schulze**. I, too, would like to welcome the former chairman of the Trade Subcommittee and mention that we did not have a trade deficit when he was chairman of the Trade Subcommittee.

He did a marvelous job. I remember very well traveling to Eastern Europe with Mr. Vanik. He is probably as knowledgeable about Eastern Europe and trade with Eastern Europe as any man in the United States of America.

We are privileged to have you here this morning, Charlie. I have sort of stolen your phrase that "world trade is the currency of peace."

You used to say that all the time. It is truer now than it was when you spoke those words. We are glad to have you.

Chairman **Rostenkowski**. Mr. Vanik, you may proceed.

STATEMENT OF HON. CHARLES A. VANIK, PARTNER, SQUIRES, SANDERS & DEMPSEY, WASHINGTON, DC

Mr. **Vanik**. Thank you, Mr. Chairman. Thank you for your willingness to bear with a former member with a history of consuming a considerable amount of time.

Being coauthor of the Jackson-Vanik amendment gives me no preemptive rights to opinion. At best, it gives me a historical perspective on the issue of normalizing United States trade between the United States and the U.S.S.R. and the reincarnated governments of Eastern Europe.

Within the limitation restrictions of private life, I have continued to monitor events and circumstances in Eastern Europe. I have traveled less than in my former life, but I did manage visits to Yugoslavia in 1988 and to Czechoslovakia and Hungary as recently as last October.

In view of the exciting changes in the Soviet Union developing under the leadership of President Gorbachev, I have been advocating a Jackson-Vanik waiver since early 1989. As you know, President Bush announced that he would propose a waiver as soon as the Soviet Union codified its laws on emigration and implemented these laws. Jackson-Vanik is the creation of the Congress and, as I understand it, it deals specifically with emigration from the Soviet Union. Although the Soviet Union has for all purposes adopted policies of free emigration, it has not yet completed the emigration codification process. Action was not completed on this issue because of other understandable priorities. However, I judge the Soviet Union by the deed more than the statute. The law is necessary, but the deed is the best indication of success.

I have urged a Jackson-Vanik waiver notwithstanding the incompletion of the codification process. In my opinion, the process appears to be in a well-established, nonreversible course. The Soviets have in effect complied with the expanded concept and interpretation of human rights of the Jackson-Vanik amendment. The recent actions of the Soviet Government beyond the immigration issue promise the freedom of religion as well as freedom of assembly.

In order to facilitate trade and the effective development of joint ventures in the Soviet Union, I urge that restrictions be lifted on the number of Soviet nationals permitted to have a commercial presence in the United States. This is part of what it takes to do business.

Beginning with the invasion of Afghanistan, our Government has imposed a ceiling on the number of Soviet commercial people in the United States. That number currently stands at 69. While the Soviets claim not to maintain a reciprocal on United States commercial presence, less obvious barriers such as the unavailability of housing, office space, and delayed approval has resulted in effectively limiting commercial presence.

In order to facilitate trade and joint ventures, I urge that additional Soviet commercial presence in the United States be permitted for an extended period on an individual case-by-case basis, at the discretion of the Immigration Service, the Department of State, the Department of Commerce, and the Department of Justice. This approach would insure that the Soviet commercial presence in the United States will have to be justified and include well-qualified, responsible people who are not likely to threaten or compromise the national security.

I must say that you should be proud of the Trade Act of 1974. I have been advised by citizens of the Soviet Union and Eastern Europe that the present changes brought about by glasnost and perestroika have resulted substantially from the great interest in human rights by the President, the U.S. Congress, and the American people. While America has fallen critically behind in the trade balance with a steadily growing trade deficit—we must not overlook the fact that America has become the world's greatest exporter of expanding concepts of human rights.

There is resistance to the granting of a Jackson-Vanik waiver to the Soviet Union. Perhaps 20 percent of the Congress and almost the same percentage of United States citizens are opposed to any relationship with the Soviet Union on the unrealistic basis that evil empires never change. Special defined portions of America's defense industry base are economically disturbed and frightened by the retreat of the cold war. There is no doubt that because of glasnost, the defense industries' job base is exposed to readjustment.

In addition to this area of concern, there are groups in America who oppose a Jackson-Vanik waiver to the Soviet Union at this time. At least one organization in the community opposes any waiver or normalization of trade with the Soviet Union until all of its ethnic members have emigrated from the Soviet Union. If we concede that this becomes a condition, it becomes a new condition and raises deep concerns if all ethnic communities are entitled to the same condition. This criteria would carry the condition to an impossible extreme. Today, the distribution of emigrants from the Soviet Union depends almost entirely on the capacity of host countries to provide entry, transportation, and adjustment for new emigres. There is also another human rights issue. Should our concept for human rights in emigration apply also to the human rights related to immigration policies of other nations. Are other nations in the world extending opportunities and doing their fair share in accommodating emigrants? Does the idea apply to those who want to move into a country as well as to those who move out? It is important that we begin to look at the comparative levels of authorized emigration. Which nations provide hospitality to new emigrants—which nations discriminate in the area of emigrant sourcing—which nations provide travel and adjustment assistance in any manner related to their economic capacity?

Having said that, I come back to the bottom line in which I urge that America provide a quick and clear response to what President Gorbachev has done, to acknowledge that we like what is going on and give the Soviet Union and its people an official signal that we acknowledge these changed circumstances. The granting of a waiver is perhaps the best available signal we have in our system. It costs very little. While our markets for imports will be expanded, the market for exports to the Soviet Union will produce a favorable balance of United States-Soviet trade long into the future.

Meanwhile, we must acknowledge the action of the President to remove countries from the Jackson-Vanik waiver list to a new category of complying states.

In this category, we must note the President's declaration on Hungary—granting MFN and eliminating the waiver process. It is my hope that the President will make a comparable decision with respect to Czechoslovakia, and later on consider that procedure for East Germany, a revitalized Romania, and perhaps Bulgaria.

This action would not repeal Jackson-Vanik, it would leave the law completely on the books. It would fully apply to the People's Republic of China, Cuba, Vietnam, Cambodia. In my opinion, the President would always have the option of withdrawing MFN under his option if circumstances warranted.

This procedure would leave in place adequate safeguards to insure the integrity of Jackson-Vanik. If a country is moved to a nonwaiver status by Presidential declaration, the President can later declare that new circumstances warrant returning a nation to the Jackson-Vanik waiver list and reinstate the full procedure of Jackson-Vanik. The Congress can return any nation to the waiver list. If that should occur, I do not believe that the President would veto a congressional decision on this matter.

I believe that the principles of Jackson-Vanik should be solidly retained in the law as a backup insurance that we will not abandon world leadership on the issue of human rights. However, I believe that when we impose human rights conditions, we should provide for uniformity and refrain from imposing a variety of special and different conditions on different trading partners. Our laws should be designed to have universal and equal application to all countries so that we avoid arbitrary discrimination among nations. We insist on equal opportunities for our people. We should also try to provide equal opportunities for our trading partners.

There is need for a prompt American reaction to the exciting events in the world. The streets of East Berlin, Budapest, Leipzig, Warsaw, Prague, Bucharest, and Sofia which were recently filled with citizens demonstrating for freedom are crowded again. This time the crowd consists of merchants and entrepreneurs of the world seeking to buy a facility at bargain prices or an option to sell a product or a system.

The question is not when American businessmen should explore the opportunities in Eastern Europe—the question is when will it be too late. No other nation in the world stands to lose so much if it continues to stand still. We must respond prudently and quickly to the exciting phenomenon of Eastern Europe awash in freedom.

Chairman ROSTENKOWSKI. Charlie, we have had some outstanding witnesses over the period of the last 2 weeks addressing immediately, yesterday and the day before, the Vanik-Jackson proposition. You are for a holding period, so to speak. A repeal is out of the question as far as you are concerned?

Mr. VANIK. I think a waiver becomes a political reality. The Eastern European countries are not a military threat. I think the President's action with respect to Hungary could be applicable almost immediately to Czechoslovakia and East Germany and maybe later on as conditions developed in Romania and Bulgaria. I think that procedure is good. I think the President's declaration was a masterful piece of legal work.

I think that that would be a good way to go in Eastern Europe. I think the rest of America is not yet prepared to go the full way for the Soviet Union. I think the time is not ripe at this time to consider anything more for the Soviet Union than a waiver, whether that period is more than a year, 1 year or 2 years, is within the discretion of the Congress.

I know businessmen need time to make decisions and they cannot be helped by restraints. I feel that the repeal of Jackson-Vanik would have a difficult time and slow down and perhaps bog down the issue in the Congress.

Chairman ROSTENKOWSKI. I like the flow of commerce. I think we are so much better off by seeing our dollars exchanged than our weapons exchanged. The businessmen who have come here who are interested in embarking on a very bold trade and exchange relationship suggested it is the redtape in the trading arena that curtails the appetite for the businessmen to get involved.

It also discourages our trading partners, whether they are going to be Eastern Europeans or Russians, from engaging in trade with us because we don't just trade, we have a moral fiber that exists when we trade.

We want certain provisions under human rights and Jackson-Vanik. There is no question about it, evidence points out that the Russians would rather do business with the Germans because the so-called moral train is not there that exists with the United States.

You know, I certainly feel that we have an obligation and we certainly had a larger club when we had all the resources and all the ability to trade. But now we are getting into a competitive arena. Frankly, I think when EC comes to fruition, it is going to be leveled out and when those European countries consolidate, they are not going to be as understanding to us as we have been to them since the Second World War.

It is not a question of when, it is a question of how and when we start moving or is it going to be too late. This is a tremendous opportunity for us. Something that we might have a blind side on is that they want us to come in. They want us to be their trading partners. They want our know-how. I think they feel we do not have as many strings attached in the long run possibly.

If we fail to recognize this and if we show somewhat of an apprehensive attitude toward these people, they are going to trade with others. As Sam says, very correctly, freedom is contagious as heck.

You know, business opportunity is contagious as heck, and the possibility of improving a lifestyle is contagious and is going to be felt in Eastern Europe. If I want to point out anything, it is the seriousness of what we are going to be embarking on in the next 3 or 4 months.

We haven't yet gotten an indication from the administration as to just how they are going to frame what they want us to legislate. This is a signal. I appreciate the fact that you——

Mr. VANIK. I think I was one of the first people to come out for a prompt waiver for the Soviet Union.

Chairman ROSTENKOWSKI. I appreciate the fact that I have an opportunity to share my views publicly with you. I met with Gorbachev 2 weeks after he was named the Secretary of the Politburo. If there is anybody going to read lips about who is helping us in a peace initiative or whatever, it is Gorbachev.

There is a man that I think we owe a great deal to, and we should support tremendously. I think that he has just changed the direction of where he wanted the Soviet Union to move. I say this because he is the younger generation of Russians. I think he sees in the future that their agricultural industry is a debacle.

He was chairman of the Agricultural Committee. So, I appreciate that fact. I don't mean to lecture you, but I appreciate all of the interest that you have shown and what you have done for us today.

Mr. VANIK. I would just like to say that I think that a 1-year waiver granted today might be more useful than a delay over one repeal issue. It would be an acknowledgment that we appreciate what is going on. Holding out for repeal might take a much longer time.

I think this positive action right now is important. Mr. Gorbachev needs some signal that we acknowledge what is going on. I think the time—time is very, very important.

Chairman ROSTENKOWSKI. Thank you.

Mr. Gibbons.

Mr. GIBBONS. Charlie, it is a real pleasure to have you back here. I appreciate how you come around to see me and tell other Members of Congress that it is time for a change. Your advocacy took a lot of courage and sacrifice on your part.

You made a good suggestion here about lifting some of these personnel restrictions. I really wasn't aware of them until I tried on a number of occasions to travel to the Soviet Union, and I found that, while it may look like they want to do business with us, they play a tit-for-tat game.

We restrict their people over here, they turn around and restrict us just the same. It is kind of like some of the wars that are still being fought around the world. People have forgotten why it was started.

If we don't let their airplanes in, they don't let our planes in. I can remember a time I sat in the Russian Embassy shaking my finger at the Ambassador, saying, "Why can't we get a visa for our planes?" They say, "How many visas do you allow for us to fly over the United States?" I am not aware of any of them.

It got me thinking. We cut the number of people we can have in this country and they in theirs. We don't allow our State Department people to even fraternize with the people that are over there. We are living in the Dark Ages still.

Even in Czechoslovakia, which has always been one of the more friendly countries, the State Department personnel are restricted almost to their quarters. You can't fraternize, you can't do anything over there.

I really think our attitude toward these people is self-defeating. I am amazed that we have done as well over there. I mean, all free people. You have to give a lot of credit to German television. They saw all these programs about freedom and about opportunity in West Germany by accident. They do listen to Voice of America. I am surprised, but they do.

I went on Voice of America one time and was surprised when I went through that part of the world, they said, "Oh, we heard you on Voice of America." So we have made the penetration of that area and been successful—in spite of ourselves.

You gave some good suggestions in your testimony. We will see what we can do to work it out. Try to carry on your fine tradition. I appreciate the opportunity to visit with you.

Chairman ROSTENKOWSKI. Mr. McGrath.

Mr. MCGRATH. No questions.

Chairman ROSTENKOWSKI. Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

Charlie, let me say that I join in this feeling of euphoria. I think it is great. I think it is wonderful, and I would like to be able to wave a magic wand and have a nice level playing field. But if we dropped these barriers tomorrow, there would not be a level playing field.

Let me take one area. When you were chairman of the Trade Subcommittee, for dumping purposes, we used, I believe, the American selling price as a standard. That is now out the window. We do not have a defensive—and Mr. Gibbons and I may get into an argument over this, but we do not have a definitive way to determine dumping from a non-market-economy country.

Perhaps, as you remember, after the last 10 years, I have been trying assiduously to determine a methodology or formula. Do you have any suggestions along this line? It seems to me, if we did drop the barriers tomorrow and just said, let's have free trade, and the first company that comes in here says, well, you know, they don't pay for their power, they don't pay for rail transportation, they don't pay for X, Y, and Z, and they are selling the product at a price for which I cannot compete.

We should have a standard, an opportunity to say no, no, no, their price is fair, it is not fair. Do you have any suggestion on how we will solve that very practical problem as the euphoria of this great period kind of diminishes?

Mr. VANIK. First of all, we have to begin with an assumption that this trade will be profitable to America. We will get more out of it than we lose. We are exposing our markets to a wider field of imports which will have to face the market test of quality and uniqueness and sophistication.

Mr. **Schulze**. You remember very well the Polish golf cart case.

Mr. **Vanik**. Yes.

Mr. **Schulze**. Where products——

Chairman **Rostenkowski**. Yes.

Mr. **Schulze**. Where we see in China today where they are developing mushrooms as an export crop. In other words, they are developing specific products to obtain hard currency. It seems to me—and if they are making a better product at a lower price, amen.

But if the government is subsidizing that product, should we just say that is fine? Will we take advantage of that subsidization?

Mr. **Vanik**. The fact is that these newly emancipated governments are not able to subsidize very much at all.

Mr. **Schulze**. The fact is that they do.

Mr. **Vanik**. In the past there were subsidy efforts. However, in their present status, I don't think they will be able to do that. They will be hard put to take care of the day-to-day necessities of their people.

Mr. **Schulze**. What should I tell a producer in my district who is competing, I don't care whether it is light bulbs or mushrooms or golf carts or whatever it is, if they go out of business and lay off 50 people because they cannot compete, what do I tell them?

That is tough, these are the seas of international trade that wash over you, and you go get a job as a carpenter somewhere. Tell me what I tell them.

Mr. **Vanik**. First of all, if Eastern Europe gets a taste of the Pennsylvania mushroom, they will want them. They are a superior product. This is a culture which enjoys the mushrooms. They will buy the American product. I understand the need for developing a test on a nonmarket economy, but we are dealing indeed with free market driven economies.

Mr. **Schulze**. Should we treat them as equal partners as developed countries?

Mr. **Vanik**. Yes.

Mr. **Schulze**. And use the same test that we use for our major trading partners?

Mr. **Vanik**. I think we should. The same test. That is precisely what they want.

Mr. **Schulze**. Congress has not done that. Should we instruct them, in your opinion——

Mr. **Vanik**. I think this committee would be well-advised to take the point you made and make it a part of the instruction to the administration.

Mr. **Schulze**. Well, how would we deal with the Soviet Union's subsidies? Currently, we cannot file subsidy cases, because they are considered a nonmarket economy. Should we eliminate that nonmarket-economy definition in column 2 and just say it is all one, big level playing field?

Mr. **Vanik**. I think we should do that to the countries to which we grant MFN. We should recognize that they are going to change certain circumstances and should be treated as free market economies. That is their hope.

Mr. SCHULZE. Where there is a clearcut case of subsidies, how should we react to that? Let's say tomorrow we open up to the Soviet Union. They don't understand the system. They want to, and they want to get that way, but they do not.

As you know, I guess almost annually, professionals and businessmen in the Soviet Union have come over here. I am one of those people with whom they have visited. I have even spent hours trying to make them understand profit, just exactly what profit is. It is going to be tough to get them into a competitive capitalist system.

How do we deal with that right now?

Mr. VANIK. Well, Czechoslovakia right now has applied for membership in the IMF and the World Bank. They are all moving and would all like to be in the society of the free traders of the world. They would like to join the club. I think all of them will seek to join GATT, do all of these things to be members of the club so that our laws would have application.

Mr. SCHULZE. So they will do everything they can to apply, and so we don't worry?

Mr. VANIK. They will make a vigorous effort to comply to our standards and needs. The Common Market will require the same sort of standards. Eastern Europe will meet our expectations.

Mr. SCHULZE. I hope you are right. I think they will make a great effort to sell products and goods in the United States of America. I hope they do it on a fair, equitable, level playing field basis, but we have to keep one eye on the fact that they may not.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Cardin.

Mr. CARDIN. Thank you. I didn't have the opportunity to serve with you, but this is not the first time that I have heard your presentations, and each time I hear your presentations, I gain more insight as to why you are held in such high regard by your former colleagues. It is a pleasure to have you before the committee.

Let me first compliment you on the work that you have done with regard to trade and human rights issues. Let me make three observations that I think are shared by most of my colleagues.

First, the Jackson-Vanik amendment worked. It was a major reason for the progress that has been made in the emigration policies within the Soviet Union. But for Jackson-Vanik, we would not have made the progress as quickly as we have in the Soviet Union.

The second observation is that the Soviet Union, based upon their record of improvement, is entitled to relief under Jackson-Vanik. No question about that. I think Congress and the President will act in that regard.

The third observation is that there are still fundamental problems within the Soviet Union because it is a different society than our society.

In the area of immigration-emigration, there still will be a 5-year prohibition on state secrets which many people think is not right. We still don't know whether the 5 years will be applied retroactively to those people who have been trying to leave the Soviet Union for a long period of time and have been denied the right to leave the Soviet Union. There are still problems within the Soviet Union as to people who applied to leave and are now being harassed on their employment.

There are problems with people who are, with their religious beliefs, being discriminated against in the Soviet Union. I guess my question to you is, As the architect of a system that was so successful in dealing with a problem that was of high importance to the United States in the world community, do you have any suggestions as to alternative ways that we can make sure that these issues are maintained as high priorities in our country in the international forums?

Mr. **Vanik**. First of all, I want to start off that America is unique with these conditions. Among the trading nations we lead the struggle for human rights. No great clamor exists in the rest of the world to join us. They use our laws, but they don't pattern their own actions after our own laws, nor do they pattern their policies of emigration with American generosity.

We do try to get a distribution of the world population into America. There continue to be some problems, and you have addressed them, but I think that the conditions of the previous regime, the Communist regime have passed. They have gone beyond immigration problems addressed by Jackson-Vanik. They have also liberated religion as a result of Jackson-Vanik.

Jackson-Vanik has had an extended effect. There is now a freedom of religion that is coming about in the Soviet Union that will make it possible for more people to be comfortable for those who decide to stay there. The pressure for emigration has become somewhat mitigated.

There is no rush of people trying to leave Czechoslovakia, most people love their countryside—their culture. There is no rush of other people really leaving, they go from East Germany to West Germany, but they don't go far. They leave with a lot of anguish, because they will become uncertain that a new place will be as good a place to live as the place they may be leaving.

The Soviets are now releasing people at a faster rate than we and other nations can accommodate them.

I think we ought to let them have MFN. We still have the power to do something about it and take it away if conditions change. Eastern Europe is on an irreversible course. To make it all perfect before we consider giving them MFN is too serious a demand.

Mr. **Cardin**. Thank you very much.

Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mrs. Kennelly.

Mrs. **Kennelly**. I thank you, Mr. Vanik, and I appreciate Mr. Cardin's thoughtful remarks. Many of us have been concerned that so many members of the Jewish race could not leave the Soviet Union. And it is a fact when they were allowed to leave, they got out.

But I want to thank you for all your work in writing Jackson-Vanik. So, I think it is up to us now who are Members of Congress to find the nuances.

I thank you for being willing to come before us now and give us the benefit of your experience.

I appreciate all you have done. Thank you.

Mr. **Vanik**. Thank you.

Chairman ROSTENKOWSKI. Mr. Guarini.

Mr. GUARINI. Thank you, Mr. Chairman.

Charlie, you are one of our most favorite people and it is great to see you again. Your legislation served the world and our Nation's foreign policy very, very well. We are in a new era, a new world, and probably will call for new tools.

Trade, of course, was your major subject matter. I guess you must be excited seeing what is happening on the global scene and how the global economy is changing. The first time I had any question about your legislation was when you led a trade mission.

I think Mr. Gibbons and Mr. Schulze and I were there. We sat down with Deng Xiaoping in China, and he said to you, "Mr. Vanik, I heard your name, Mr. Vanik. I have 100 million Chinamen for you." I think that story was told yesterday by Mr. Gibbons.

Mr. GIBBONS. He said, "How many more will you take?"

Mr. GUARINI. At that moment, I began to wonder whether or not, if you could—if it will fulfill the greatest dreams that we have had. But, nonetheless, it really served extremely well. I am concerned now in the new economy that we are in. We need some new answers. Businessmen do want to be protected in their investments, and it is important that we get on board in all these other countries.

They want certainty, they want permanency. They want to be able to plan long range. When you go 1 year at a time, I know that I would be reluctant to invest in any plant that I put up 1 year at a time or 3 or 5 years at a time.

I want to make sure that I knew that the investment is protected. All these other countries don't have Jackson-Vaniks who are our major trading partners. They are reshaping the tax laws to meet the new world, to encourage corporate investments in these new markets that are opening up.

We have been listening to that for the past 2 days What we have to do now is think of where the nuances are. Now, we have heard people talking about granting MFN status, modifying export controls, being a GATT observer, joining GATT, and modifying our OPEC and Exim pact, et cetera.

But as Mr. Schulze had pointed out, how do we handle what is going to happen in the marketplace where there is not the verbal currency? Where there is great subsidization and that they have distorted prices? It brings me to the point that until there is convertible currency, perhaps we have got to rely on new tools. I am asking you whether or not you have any thoughts on that matter, because I know we talked about barter, countertrade.

This may be a way for the Third World to go and for the new world that is opening up in Eastern Europe and Russia and China, et cetera, where there is no marketplace that pertains to their currency or commodities.

Do you have any thoughts that you can exchange with us on how to handle barter or trade that would be applicable now?

Mr. VANIK. With respect to the currency, I would like to point out that Hungary is practically on a hard currency basis now. You can't do anything with the local money. The cab driver will throw it at you. The country really is moving very, very quickly to a hard currency system, their own or that of another nation.

I think this pattern will follow throughout all of Eastern Europe. There probably is more hard currency there than we imagine. These are thrifty, provident people and they have been saving, hoarding, and collecting. They probably have some of our big-size American dollars stashed away somewhere there.

I think the marketplace will move these nations more rapidly to the solution of the currency problem than anything we do. They should have a little time. You made a very, very important point in seeking other recommendations, but I would like to have the opportunity to prepare a document and send it to you and have it included in the record in response—a fuller response to your question. I think I would like to have a little more time to review that one before I try to respond.

Mr. GUARINI. I do know that you have some thoughts on trade and countertrade that could be important to us. If you can afford us the benefit of your experience, we thank you. You have an institutional memory, having been here some 30 years past, that is unequal in the trade and in Congress.

We appreciate your thoughts.

Mr. VANIK. That institutional memory is not all that good. The other day, I fell asleep at the telephone, talking to a partner.

Mr. GUARINI. Let me say any thoughts, any philosophy, or any ideas that you have, this committee will appreciate, as always, your thinking.

Chairman ROSTENKOWSKI. Mr. Pease.

Mr. PEASE. Thank you, Mr. Chairman.

I would like to welcome my friend and colleague, Charlie Vanik, back to the committee. We don't have official higher chairs in the Ways and Means Committee, but I remember that it was your retirement in 1980 which allowed me to come on this committee. I felt I have had very large shoes to fill in the intervening years.

I was interested in one aspect of your testimony, Charlie, where you said at one point that we must not overlook the fact that America has become the world's greatest exporter of expanding concepts of human rights.

I think that is very felicitous wording. And then you say later on that the principles should be solidly retained in the law as a backup insurance. We will not abandon world leadership on the issue of human rights.

Yesterday, we had business witnesses who suggested to us that if the Soviet Union and East bloc countries comply on the narrow grounds of Jackson-Vanik, that is, emigration policy, that we ought to grant full MFN status to each one of those nations. They suggested repealing the law, but certainly short of that, they would suggest waivers.

In your testimony when you are talking about human rights, are you suggesting at all that we should condition our trade policy, whether it is extension of MFN or any other trade benefit, to a country's record of human rights? That is, more broadly than just emigration?

Mr. VANIK. Well, I addressed part of that when I talked about discrimination between countries. There are efforts in the Congress that I see and observe in which they seem to be drafting conditions that are especially designed against the Soviet Union which do not apply to anyone else.

It is one thing if a policy applies goes across the board to all of our trading partners. But there are so many of our trading partners that could never meet the standards of the so-called Slepak resolution.

We would have to probably cut out business with half of our partners if we had those same principles apply to their trade. When we do something, it should apply uniformly, so that it could work uniformly instead of having something that is designed for or against a special nation or group of nations.

I applaud the widening of the concept of human rights that has now become part of the stretching out of Jackson-Vanik. But I say that under the law, it is still very clear, the law relates to emigration. The legislative history relates to emigration. I think perhaps it is time for us to consider more seriously how much and how the expansion of the human rights idea can—should prevail.

I think that right now that the direction we experience in Eastern Europe and the Soviet Union, not only a relation of emigration but also of religious considerations. I think that the emancipated multitudes have a chance to go back to their former religion, to their former religious activity.

There is a lot that they have done. I don't think that we should ask that everything be done before we commence normal trade. I think we should commence trade and let the process develop. Give it a chance to produce those further goals which I know you support and which I applaud.

I must tell you, Mr. Pease, that I haven't ended with my concept of human rights. As I said in my statement, I think we should look at which nations open their doors, which open up for some of emigration and which do not. I think we set something going in the world with our Statue of Liberty which was important to the whole world.

I think we should continue to do that. The sidewalk of the building here is curved for handicapped. Hubert Humphrey and I worked on the civil rights for the handicapped. My next project is to fight for pedestrian rights now that walking has been returned to fashion.

I am now talking about pedestrian rights. I want to applaud you for your very wide interest in carrying on the torch much more effectively than I ever could in my time.

Mr. PEASE. Thank you very much.

Chairman ROSTENKOWSKI. Mr. Levin

Mr. LEVIN. Thank you, Mr. Chairman.

Welcome, Charlie. It has been a real pleasure coming to know you.

Let me, if I might, focus on Jackson-Vanik and the issue of further action by the Soviet Union before a waiver takes place. It is my guess, maybe my judgment, that the moment is very, very close.

The question is, Is it now? You make the suggestion that it is now, that we don't want to wait for perfection and that deeds speak louder than words. You put the statute that is being considered by the Soviet Government, by its parliament more or less, in the category of words rather than deeds.

I think that is maybe one or the one remaining question. Should we insist before there is a waiver, if not insist, wait before a waiver on a codification process so that what is now practice becomes something that can't be theory 6 months from now?

Mr. Cardin and others raised a question about certain practices that continue within the Soviet Union. For example, a matter came to our attention and that of many other members some months ago about a resident of the Soviet Union who has been denied the ability to leave because of alleged access to state secrets. It doesn't appear that he really ever had such access. He never worked with classified material.

His case goes back to a period when he studied at an institute and then he worked on mathematics. His case was presented by the President to Mr. Gorbachev, and he is still waiting. He is one of many.

But your strength has always been to focus on the individual, not just on numbers. So here we have this person and others who are essentially trapped within the Soviet Union because of the alleged access to state secrets.

So, my question is this: I agree we should not wait for perfection. I also very much agree there has been major, indeed remarkable progress. I also agree very much that we should be supportive of Mr. Gorbachev's efforts, including emigration.

But should we await codification? It could be just a few months. Should we not insist on, or await the embodiment of practice in the statute? I think you agree as someone from this body—a statute is more than words, it is the crystallization of action. It is the affirmation and it is the—more than affirmation, it is the concretization of words and of action.

Mr. VANIK. I feel that if we use the infinite test of meeting every person's needs, it is carrying the restraint further than is practical. If we put that ultimate test on new policy in trade, it may take us out of these markets at a critical time.

I think we have to be wise in what we do and address ourselves to the solution of the problem, but to rely on the 1,000 percent performance is putting too high of a standard here. As much as I consider the plight of each person, he is now living in a better country, in the Soviet Union. He now has the freedom of his religion.

He is not under as controlled a situation as he was 1 year ago. His lifestyle is changed. I would expect that, in its wisdom, the Government of the Soviet Union will endeavor to accommodate all of these needs. The rapid change in Eastern Europe will very quickly erode national suspicion and distrust. The more we are involved in normalizing trade—quicker human rights will develop a mutual parity.

Chairman ROSTENKOWSKI. Thank you.

Mr. Vanik, thank you very much for joining us this morning. You have been most helpful.

Mr. Pettibone, Ms. Carey, Mr. Theroux, Mr. Hammer.

Welcome, to the committee. We would like for you to identify yourself as you enter your testimony. You all understand the constraints that we are working under. We would appreciate that. If your statement is longer than the allotted time, maybe you could summarize.

Mr. Pettibone, you may begin.

STATEMENT OF PETER J. PETTIBONE, PARTNER, LORD DAY & LORD, BARRETT SMITH, AND U.S. COCHAIRMAN, LEGAL COMMITTEE OF THE U.S.-U.S.S.R. TRADE AND ECONOMIC COUNCIL, INC.

Mr. PETTIBONE. Mr. Chairman and distinguished members of the committee. I am Peter Pettibone, a partner in the law firm of Lord Day & Lord, Barrett Smith in New York City. I appreciate the privilege of addressing this committee on the important and timely subject of our Nation's trade policy with the Soviet Union.

The rapid political changes which have occurred in Eastern Europe during the past few months, the improvements in emigration and other human rights in the U.S.S.R. and the continuing democratization of the Soviet Government through national and the soon-to-be-held local elections, have created a new business environment and many new opportunities for trade and investment in the U.S.S.R.

Businessmen in other Western countries and in the Far East are moving rapidly to take advantage of these opportunities. However, our businessmen are falling behind, in part because of trade constraints.

The first is the lack of MFN. As the members of this committee are well aware, the President at Malta set as a goal the conclusion of a trade agreement with the Soviet Union this June which will grant reciprocal MFN treatment. The President has said that, if the Soviet Union enacts an emigration law this spring, he will seek a 1-year waiver of Jackson-Vanik. This move appears to have widespread support, including among organizations which monitor emigration levels.

In my view, this development, while very positive, does not go far enough. Joint ventures are long-term arrangements which need the stability of an assured long-term MFN. The improvements in emigration and human rights in the Soviet Union in recent years justify, in my opinion, the repeal of Jackson-Vanik or at least a long-term waiver.

This action would both acknowledge these improvements and symbolize a commitment by the United States to expand trade and investment with the U.S.S.R. to a significantly larger scale. Historically, our trade balance with the U.S.S.R. has been positive, yet the level of trade has been very low. I anticipate that if we were to repeal Jackson-Vanik or grant the Soviet Union a long-term waiver, we would shortly see the benefits of this in a significant increase in both our grain trade and our industrial trade.

I also recommend that this committee move forward on legislation to repeal the Stevenson and Byrd amendments, which effectively ban export credits and loan guarantees by the U.S. Government and its agencies, including the Export-Import Bank, for U.S.S.R. transactions.

American businesses are at a definite competitive disadvantage when other countries are able to provide credits and loan guarantees for transactions in the U.S.S.R. by their companies.

I also recommend that a thorough revision of our export control regulations be undertaken in coordination with the other members of COCOM. The goal should be to restrict only that which is truly sensitive and to have the restrictions applied uniformly by all COCOM members. Particularly in this area, we need to have a level playing field.

Another trade constraint is the administration's policy of limiting the number of Soviet nationals permitted to have a commercial presence in the United States and visa restrictions applicable to Soviet trainees. These restrictions artificially impede the expansion of commerce and should be lifted or significantly increased.

The lack of an investment protection treaty with the U.S.S.R. has caused some companies to invest through countries which already have such treaties, for example Finland, Belgium, West Germany, Great Britain, and Canada.

While it is, of course, possible to structure American investments through such countries, this adds an extra layer of documentation and additional expense, as well as being time-consuming. I encourage this committee to hold further hearings on the desirability of an investment protection treaty with the U.S.S.R.

Another favor which results in American joint venture investments being made through third countries is the lack of favorable Soviet tax treatment accorded to dividends paid to American companies. A protocol to the 1973 U.S.-U.S.S.R. Income Tax Treaty which would have exempted these dividends from Soviet taxation was initialed in 1979 but shelved when the Soviets invaded Afghanistan.

It is now time to amend the U.S.-U.S.S.R. Income Tax Treaty to provide this exemption. The result will be that American companies establishing joint ventures in the U.S.S.R. will no longer need to consider forming subsidiaries in such countries as Cyprus or Austria, which currently have treaties providing an exemption for dividends.

In conclusion, improved trade relations with the U.S.S.R. benefit us economically and lead to further stability in our overall relations. I am pleased that the administration has placed trade issues on the agenda for the June summit.

Given the fundamental and largely irreversible changes in Eastern Europe and the U.S.S.R., we should remove the current constraints on trade and investment, so that U.S. companies may compete effectively for the new trade and investment opportunities available in the U.S.S.R.

Thank you for the opportunity to present these remarks. I would be pleased to answer any questions that you, Mr. Chairman, or other members of the committee may have.

Chairman **Rostenkowski**. Thank you, Mr. Pettibone.

[The statement of Mr. Pettibone follows:]

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PREPARED STATEMENT OF
PETER J. PETTIBONE
PARTNER, LORD DAY & LORD, BARRETT SMITH,
NEW YORK, N.Y.

BEFORE THE COMMITTEE ON WAYS & MEANS
U.S. HOUSE OF REPRESENTATIVES
JANUARY 31, 1990

Mr. Chairman and distinguished members of the Committee, I appreciate the privilege of addressing the Committee on the subject of our nation's trade policy with the Soviet Union. I have been practicing in the field of U.S.-U.S.S.R. trade for nearly twenty years as an attorney in the private sector. I am also the U.S. Co-chairman of the Legal Committee of the U.S.-U.S.S.R. Trade and Economic Council, which is a bi-national committee of attorneys which has met periodically to consider legal issues in the field of trade and investment.*

I applaud the Committee for holding these hearings on this important and timely topic. In my practice, I have observed that our trade policy with the U.S.S.R. has sought to fulfill important strategic and human rights goals, as well as commercial goals. For example, as you are well aware, the 1974 Jackson-Vanik Amendment conditions most favored nation status ("MFN") to the U.S.S.R. and certain other Communist countries on their emigration practices. Another example of this was the imposition in 1981 and 1982 of restrictions on the supply of equipment for construction of the Urengoi natural gas pipeline to protest the Soviet role in the imposition of martial law in Poland.

Our trade policy with the Soviet Union is thus more complex than the trade policies of many of our allies, where the principal, and in some cases the only, interest is a commercial one. As a result, since our trade policy often has sought to restrict trade with the Soviet Union in order to accomplish other goals, our businessmen have been at a distinct disadvantage in their commercial transactions in the U.S.S.R., as I will describe in these remarks.

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* The U.S.-U.S.S.R. Trade and Economic Council is a non-profit membership corporation whose charter prohibits it from engaging in political or lobbying activities. The remarks in this statement are personal and do not necessarily reflect the views of the Trade Council.

The rapid political changes which have occurred in Eastern Europe during the past few months, the improvements in emigration and other human rights in the U.S.S.R. and the continuing democratization of the U.S.S.R. Government through national and the soon-to-be-held local elections, have created a new business environment and many new opportunities for trade and investment in the U.S.S.R. Businessmen in other Western countries and in the Far East are moving rapidly to take advantage of these opportunities. However, our businessmen are falling behind in taking advantage of these opportunities, in part because of the following trade constraints: (1) the lack of MFN, (2) restrictions on U.S. Government export credits and loan guarantees, (3) the way in which our export controls are administered, (4) visa restrictions, (5) the lack of an investment protection treaty and (6) the less than favorable tax treatment accorded U.S. investments in the U.S.S.R. under the present terms of the U.S.-U.S.S.R. Tax Treaty.

As an attorney representing clients engaged in investment and trade transactions in the U.S.S.R., I have found it possible to structure transactions so as to work around some of these constraints, but the result is time consuming and expensive. In certain cases, the constraints cannot be overcome, and the transaction cannot be consummated.

The Lack of MFN

The lack of MFN means that American-Soviet joint ventures are often not able to sell their products in the United States competitively. For many American companies, the logical market for products produced by their joint ventures is the United States. They do not have extensive distribution arrangements in other parts of the world, and their products are principally known in the United States. Thus, if an American company and a West German company are competing for the same export-oriented joint venture opportunity, the West German company will have a distinct competitive advantage in the negotiations, since the products of the joint venture will be accorded MFN treatment in West Germany.

Also, since the tariff structure in the U.S.S.R. is based on the principle of reciprocity, the lack of MFN may mean that higher duties will be imposed on U.S. goods imported into the Soviet Union, making exports of U.S. goods to the Soviet Union less competitive.

As the members of this Committee are well aware, the consequences of the lack of MFN status are being addressed by the Administration. The President at Malta set as a goal the conclusion of a trade agreement with the Soviet Union this June which will grant reciprocal MFN treatment to products of the two countries. The President has said that if the Soviet Union enacts an emigration law this Spring, he will seek a one-year waiver of the restrictions of the Jackson-Vanik Amendment. This move appears to have widespread support, including among organizations which are monitoring emigration levels.

In my view this development, while very positive, does not go far enough. Joint ventures are longer-term arrangements and need the stability of an assured longer-term MFN arrangement. The improvements in emigration and human rights in general in the Soviet Union justify in my opinion the repeal of Jackson-Vanik or at least a long-term waiver of its restrictions. This action would acknowledge the significant improvements which have been made in emigration and human rights in the Soviet Union and would symbolize a commitment by the U.S. to expand trade and investment with the U.S.S.R. to a significantly larger scale than has been the case to date. Historically, our trade balance with the U.S.S.R. has been positive, yet the level of trade between the U.S. and the U.S.S.R. has been very low. Grain trade constitutes approximately two-thirds of U.S.-U.S.S.R. trade. Industrial trade between the two countries has averaged less than $1 billion per year. I expect that if we were to repeal Jackson-Vanik or grant the Soviet Union a long-term waiver from its restrictions, we would shortly see the benefits of this in a significant increase in both our grain trade and our industrial trade with the U.S.S.R.

Restrictions on U.S. Government Export Credits and Loan Guarantees

A second trade constraint, which was implemented at the time of the enactment of the Jackson-Vanik Amendment, is the restriction on export credits and loan guarantees by the U.S. Government and its agencies, including the Export-Import Bank, imposed by the 1974 Stevenson and Byrd Amendments. American businesses are definitely at a competitive disadvantage when other countries are able to provide credits and loan guarantees for transactions in the U.S.S.R. by their companies. Repeal of the Stevenson and Byrd Amendments would have a direct positive impact on our competitive position, and, in light of the fundamental changes in Eastern Europe and the U.S.S.R., I encourage the Committee to move forward on legislation to repeal these two amendments.

Export Controls

Both our export control regulations and the way in which they are administered are constraints on the ability of our companies to compete in the Soviet market. Obviously, strategic controls are important and should be preserved. But, too often, excessive time is spent by the Administration in ruling on applications for export licenses for equipment and technology which are readily and legally available to the Soviets from other countries. What progress is being made by the Administration in refining the process of export control appears to be on a case-by-case basis. This is wasteful. Businessmen need clarity and certainty. Rather than the current piecemeal approach, I urge that, in light of the fundamental changes in Eastern Europe and the U.S.S.R., a thorough revision of our export control regulations be undertaken in coordination with the other members of COCOM. The goal should be to restrict only that which is truly sensitive and to have the restrictions applied uniformly by all COCOM members. Particularly in this area, we need to have a level playing field with our competitors.

Visa Restrictions

Another constraint on the expansion of commercial relations between the two countries is the Administration's policy of limiting the number of Soviet nationals permitted to have a commercial presence in the United States and visa restrictions applicable to Soviet trainees. Some of these restrictions date from the Cold War period. Others are new and appear to reflect a concern on the part of the Administration that too many Soviet nationals are entering the United States for commercial and training purposes. These restrictions artificially impede expansion of commerce between the two countries and should be lifted or significantly increased, so that applications by Soviet nationals for visas for commercial and training purposes can be determined on a case-by-case basis by the Immigration and Naturalization Service, the Department of State, the Commerce Department and the Justice Department.

The Need for an Investment Protection Treaty

The President at Malta stated that he will consider discussing an investment protection treaty with the U.S.S.R. Such a treaty should be concluded, because it will encourage U.S. direct investment in the Soviet Union. The lack of such a treaty has caused some American companies to invest through countries which already have investment protection treaties with the U.S.S.R., such as Finland, Belgium, West Germany, Great Britain and Canada. While it is of course possible to structure American investments through a country which has concluded such a treaty, this adds an extra layer of documentation and additional expense, as well as being time consuming. I encourage the Committee to hold further hearings on the desirability of an investment protection treaty with the U.S.S.R.

The Lack of Favorable Tax Treatment for Dividends

Another factor which results in American joint venture investments being made through third countries is the lack of favorable Soviet tax treatment accorded to dividends paid to American companies. The 1973 U.S.-U.S.S.R. Income Tax Treaty is silent on the subject of dividends, with the result that dividends payable to American companies are subject to a 20% Soviet withholding tax. Several countries, such as Cyprus and Austria, have income tax treaties with the U.S.S.R. which exempt dividends paid to companies in those countries from the 20% Soviet withholding tax. A protocol to add this exemption to the U.S.-U.S.S.R. Income Tax Treaty was initialed in 1979 but shelved when the Soviets invaded Afghanistan. It is now time to amend the U.S.-U.S.S.R. Income Tax Treaty to provide this exemption. The result will be that American companies establishing joint ventures in the U.S.S.R. no longer will need to consider forming subsidiaries in countries such as Cyprus in order to achieve favorable tax treatment for dividends.

In conclusion, improved trade relations with the U.S.S.R. benefit us economically and lead to further stability in our overall relations. I am pleased that the Administration has placed trade issues on the agenda for the June Summit. Given the fundamental and largely irreversible changes in Eastern Europe and the U.S.S.R., we should remove the current constraints on our trade with, and investment in, the U.S.S.R., so that U.S. companies may compete effectively for the new trade and investment opportunities there.

Thank you for the opportunity to present these remarks. I would be pleased to answer any questions that you, Mr. Chairman, or other members of the Committee may have.

Chairman ROSTENKOWSKI. Ms. Carey.

STATEMENT OF SARAH C. CAREY, PARTNER, HERON, BURCHETTE, RUCKERT & ROTHWELL, WASHINGTON, DC

Ms. CAREY. Thank you, Mr. Chairman.

It is an honor to be able to present my views to the committee. My remarks are based on my representation in my legal practice of three dozen or more U.S. corporations that are actively pursuing commercial opportunities in the Soviet Union.

I would like to second the comments that the corporate representatives made earlier to this panel that reflect the fact that this market is literally exploding. We are representing companies from almost every sector of the U.S. commercial spectrum, everything from food processing to entertainment to capital goods and mining, to services and infrastructure.

There is no longer an industry, with the exception of the military, for which there is not a potential business partner in the Soviet Union. The stark fact is that this is a dramatic and huge market that is opening for the first time in decades, for a country with a significant trade deficit it represents enormous opportunities.

I frankly am thrilled to hear the reactions of members of the panel to this opportunity and their recognition that trade is becoming the growth element in the bilateral relationship. You are faced with the historical challenge of taking a relationship that has been primarily hostile and dominated by the military, and transforming it into one that will be primarily dominated by trade and economic relations. How those policies are shaped is going to be extremely significant for America and for the Soviet Union.

As you all know, the trade levels are very small in terms of macro figures right now. In addition, the Soviet economy is doing very poorly if one reads all the critics and the economists with their skills at 20-20 hindsight analysis.

But what is striking to the American business community is that the trend line is in the right direction. Dramatic reforms in the economy have already occurred that make the Soviet Union an inviting place for investment. Zigs and zags in the definition and implementation of economic reforms are occurring. But the trend line is in the right direction, toward decentralization, increased democratization and destatization or privatization.

American companies can now trade directly with any manufacturing partner wherever it may be located in the Soviet Union, can invest in the Soviet Union through joint ventures, can create subsidiaries in free economic zones, and can lease assets that previously belonged to the state, such as state enterprises and so on.

There is a lot more to come, and a lot more reforms on the drawing boards, but even these steps have made it appealing for companies such as Combustion Engineering to invest and plan for the future.

Although the Soviet Union may not for a decade or decades be a major trading partner for the United States in certain industries it will be extremely significant. Against that background, I would urge the Congress to move as expeditiously as possible to implement all the initiatives that the President proposed at Malta.

I recommend repeal of Jackson-Vanik and grant a most-favored-nation status to the Soviet Union. One point that hasn't been made, I think, is that the denial of MFN tends to prejudice medium and small corporations. Large corporations that are selling to the U.S.S.R. can buy back the products and sell them anywhere in the world. They don't need to import the products into the United States as long as MFN is denied. Smaller companies don't have global operations, and consequently don't have worldwide distribution.

When they try to bring the products into the United States to counterbalance the trade, they suffer very high tariff rates.

I don't want to repeat the chorus that you are hearing on Export-Import Bank credits. I think they are also essential.

I think the treaty framework, particularly in regard to investment protection and taxes is, as Mr. Pettibone has emphasized, extremely significant. United States companies are really at a disadvantage compared to almost all of the European countries that have very explicit treaties protecting their investments in the Soviet Union, and tax treaties that reduce the profits tax on joint venture earnings dramatically below the double taxation that exists in the United States.

I have clients that become involved in contorted tax planning and have to do their deals through an Austrian subsidiary or create a Cyprus corporation to avoid the more onerous tax situation that exists when it is a bilateral United States-Soviet transaction.

I would note that all of the measures that the President proposed at Malta are primarily measures that would put trade with the Soviet Union in a nondiscriminatory position. They don't grant any privileges or any special treatment to the Soviet Union, but basically put the U.S.S.R. at the same level as a Honduras, a Chad, or any other insignificant trading partner.

The committee is now faced with the opportunity to look beyond simply the elimination of discriminatory policy to the crafting of an affirmative policy. A broad range of issues should be examined in that context. First and foremost is export controls; the controls continue to cost time, money and deals. No matter what standards Congress seems to enact, the administration somehow succeeds in implementing a more onerous policy than our allies have.

There are great delays, particularly where exports are made to joint ventures. The economic factor, the importance of a deal is hardly ever weighed or put in the balance. All of those things need to be addressed when the Export Administration Act comes up for renewal.

The point that Congressman Vanik and Mr. Pettibone have made about restrictions on Soviets living in the United States is important, but I would go beyond that and look at all the restrictions on the travel and movements of citizens from each country in the other's country. These restrictions are very inhibitive in doing business on a normal basis.

It takes 4 to 6 weeks to get a business visa for a Soviet out of the State Department. The Soviets, for their part, have restrictions on travel to different parts of the country. If you can't move around freely, you can't do business freely. These restrictions should be addressed.

I think we also should look at whether or not the United States shouldn't make trade development assistance available to United States companies exploring the Soviet market on the same terms that we do for exploration into other countries.

That would include assistance for market development activity from USDA and assistance from TDP at AID for feasibility studies, and a number of other programs that are covered now by various agencies of the U.S. Government in regard to other parts of the world.

Overall, we need to look at other questions, such as the role that United States companies might play in developing the Soviet Far East, the part of the Soviet Union that borders the Pacific, a region that is very rich in all kinds of minerals and natural resources.

We need to look at ways that we might collaborate in developing countries on major development projects. We need to examine industries where our interests are likely to be closely interlinked, such as collaboration between companies previously involved in military production in the development of new technologies for the civilian sector.

There needs to be 5- to 10-year thinking and not just 1-year thinking or 2-month thinking.

On the question of human rights issues as they tie into trade, I think that the time has come to move human rights and social issues into another arena. They never really fit trade. This mismatch of objectives didn't matter when the Soviet Union was not a significant potential market and was basically closed off to the rest of the world.

Today, it matters tremendously, economically. The human rights issues can be better handled through the whole. The Helsinki process which is now institutionalized and respected and commands the energies of many of our allies around the world.

I would like to close by saying that it really is thrilling to hear this panel address the real potential of trade and economic relations with the Soviet Union and with Eastern Europe. It is a very exciting opportunity, one that offers the United States much, both financially and otherwise, one that can help to stabilize the whole perestroika process. It is delightful to see that perestroika has reached Congress on this issue.

Thank you very much.

[The statement of Ms. Carey follows:]

PREPARED STATEMENT OF
SARAH C. CAREY
PARTNER, HERON, BURCHETTE, RUCKERT & ROTHWELL
WASHINGTON, D.C.

BEFORE THE COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
JANUARY 31, 1990

Mr. Chairman, distinguished Congressmen, thank you for the opportunity to testify. My remarks are based on my experience in representing several dozen U.S. corporations that are seeking business opportunities in the U.S.S.R. and on my studies of, and travel to, the U.S.S.R. over three decades.

Let me say at the outset that Malta represented a major turning point in the policy of the Executive Branch towards trade with the U.S.S.R. The President supported the repeal of the Jackson Vanik Amendment and the grant of most favored nation ("MFN") status to the U.S.S.R., the repeal of the Stephenson Amendment and the removal of restraints on U.S. Export Import Bank credits and guarantees for commercial transactions in the U.S.S.R., the negotiation of a bilateral trade agreement (a prerequisite for the grant of MFN) and of bilateral investment protection and tax treaties. In addition, the President supported observer status for the U.S.S.R. in GATT, expanded U.S.-Soviet technical economic cooperation, and improved ties between the Soviets and the OECD and the economic basket of the Conference on Security and Cooperation in Europe.

Taken together, these policies constitute a commitment to treat the U.S.S.R. in a non-discriminatory manner in regard to trade. They do not represent the grant of any special privileges or subsidies to the U.S.S.R. but merely a commitment to accord the U.S.S.R. the same treatment that is accorded our lesser trading partners.

It is my hope that the Congress will move promptly to follow the President's lead and to enact the legislation necessary to remove the remnants of the Cold War treatment of trade with the U.S.S.R. It is also my hope, and that of many of the corporations that I serve, that the Congress will go beyond this de minimis position and take steps to insure that American corporations are given opportunities equal to those of their competitors from Western Europe and Asia to participate in one of the world's largest untapped markets. This means that the Committee should look beyond Jackson Vanik and the trade treaty and examine all of the conditions that currently obstruct trade with the U.S.S.R. A new pro-trade policy should be developed in regard to this vast market. This policy should be totally independent from human rights or other "social reform" goals and should, to the extent it involves any form of "linkage," seek only concessions from the Soviets that impact foreign trade.

First, it is necessary to look at the factual context surrounding U.S.-Soviet trade. During the first 3 quarters of 1989, two-way trade totalled $3.7 billion with sales from the U.S. constituting $3.2 billion of the total. Of that amount, 81% were agricultural sales. The total turnover was less than 1% of total U.S.-Worldwide trade. Although the figures reflect a steady growth since 1986, they are still considerably below the $4.5 billion in two-way trade reached at the peak of detente in 1979.

Also of interest is the performance of the Soviet economy. On January 26, 1990, the Financial Times reported that the Soviet economy is in a state of crisis. Year end figures show "huge pent-up inflation, stagnating production and investment, and a failure to meet targets in almost every major economic sector." Not surprisingly, perestroika is causing more dislocation than it is improvement in the economy. Given the current situation, liberalization of trade policy will not open the floodgates next year or the year after, but the long-term U.S.-Soviet trade relationship should be a significant one, particularly in certain industries.

It is our prediction that over the next five years both U.S.-Soviet trade levels and Soviet economic performance will increase significantly. The trade figures are already beginning to reverse and many major U.S. companies are in the process of negotiating joint ventures and other transactions that will significantly increase U.S. investment and sales in the U.S.S.R. In addition, despite confusing zigs and zags, the Soviet Union continues to follow a course of economic reform that has already dramatically opened the country to foreign commercial participation. These reforms include: the abolition of the monopoly on foreign trade, with the resultant direct participation by all manufacturing concerns -- and a host of other organizations in foreign trade; the encouragement of foreign investment through joint ventures; the announcement of foreign economic zones where wholly-owned foreign subsidiaries may be created with special privileges; the enactment of a leasing law that permits foreigners to acquire a 50-year or longer leasehold interest in state enterprises, kolkhozes and other property; and the proposed enactment of a host of other laws that will "de-statize" and open up the economy. The U.S. should do everything in its power to encourage and help stabilize these reforms and to assist U.S. companies in participating in the resulting market opportunities.

My recommendation to the Congress is to conduct a broad review of U.S. trade policy towards the U.S.S.R. with the objective of encouraging constructive, commercially sound U.S. participation in the development of the Soviet economy and vice versa. Among the measures that should be considered are:

- Full implementation of the President's Malta commitments. Work is already underway on the trade and investment protection treaties and the Export Import Bank is reviewing options for participation in the U.S.S.R. In addition, Congress should encourage the Administration to establish a special office, headed by an individual of Ambassadorial rank to coordinate efforts to provide technical assistance to the Soviet economy. Ad hoc, uncoordinated efforts will have only minimal impact.

- Overhaul of the Export Control Laws. The Export Administration Act is up for renewal in 1990. This creates a major opportunity for harmonizing that law with the new bilateral relationship. As presently structured, the export control regimen costs U.S. businesses billions of dollars annually in lost opportunities. At the least, the law should be amended to reduce the range of goods controlled; to promptly abolish all unilateral controls, to treat exports to joint ventures in the same manner that exports to other end-users are treated, and to require consideration of the economic significance of each export transaction as a key factor in the decision of whether or not to license. In addition, the Department of Commerce should be given sole responsibility for processing license applications to avoid duplication of effort and processing time. Finally, we question whether the proposed differentiation of licensing policy among East European countries and the U.S.S.R. is either politically acceptable or enforceable.

- Adoption of general principles to govern all aspects of trade and commercial relations. We recommend that an umbrella trade treaty establish broad principles of fairness and reciprocity that will apply to all transactions and all industries. Separate, industry-specific agreements governing maritime trade, agricultural trade and other sectors that conform with these broad principles can then be negotiated separately.

- Liberalization of travel and residency requirements for businessmen. Both countries should be required to normalize the rules that govern the movements within their borders of businessmen from the other country. On the U.S. side, the State Department should be required to process Soviet business visas in a matter of days, as the Soviets do for American businessmen (despite the fact that the volume of travel is much greater from the U.S. to the U.S.S.R.).

Better yet, businessmen should be permitted to travel with visas that are valid for up to a year and for repeated trips. The U.S.S.R., for its part, should take the KGB out of the travel business and permit foreign businessmen to travel throughout the U.S.S.R., with limited exceptions.

- Opening up of U.S. Commercial Offices outside of Moscow. The Congress should appropriate funds to create new commercial offices in such population centers as Leningrad, Kiev and Tashkent. Special consideration should be given to the port city of Nakhodka in the Soviet Far East, which is targeted for major economic development and for a key role in relating the U.S.S.R. to all the countries that border the Pacific Ocean.

These policies are all intended to assist U.S. businessmen to participate more effectively in the Soviet market and on an equal footing with their competitors. They are strictly trade-oriented, with the exception of the President's proposal that the U.S. provide technical economic assistance. If, after due deliberation, the Congress decides that further steps should be taken to affirmatively assist the perestroika process and to ensure that the process of decentralization and democratization continues, then further steps that benefit both the Soviet and the U.S. economies should be considered. These might include: the grant of GSP status to certain Soviet imports, the creation of incentives to encourage certain U.S. industries, such as manufacturers of health care, food processing, or environmental protection products, to participate in the Soviet market and/or the extension of various U.S. trade development assistance programs (for both agricultural and manufactured goods) to the U.S.S.R. Special consideration might be given to support U.S.companies seeking to participate in infrastructure construction projects in the U.S.S.R., and so on.

Whether or not the objective is the elimination of discriminatory treatment or active support for perestroika, in defining the new rules governing trade the U.S. should seek wherever possible to encourage the Soviets to adopt laws and policies that reduce protectionism and open the economy, protect foreign investors, make the legal system both transparent and accessible, and that conform with the basic rules governing international trade.

The policies discussed above are all fairly obvious, based on current developments in U.S.-Soviet relations. In addition, Congress should begin a broad inquiry into the long-term directions in which U.S.-Soviet trade might move. Among the questions to be addressed are the following:

- How will the U.S.S.R. and the various countries of Eastern Europe relate to the EC in 1992 and beyond? What impact will this have on the U.S. relationship to the EC and to Eastern Europe?

- What will the U.S. response be to Soviet and/or East European investment in the U.S? (Soviet enterprises earning hard currency are now encouraged to invest in Western markets. Soviets are also actively looking for joint venture opportunities in the U.S.).

- What new roles might the two countries play in the Pacific region and what impact might that have on the economic balance of power in that region? (The Soviets are renaming Nakhodka Bay America Bay and U.S. companies, like their Asian counterparts, are actively exploring investments in the region.)

- Is there any room for collaboration by U.S. and Soviet companies that are converting from military to peacetime production -- particularly in regard to the joint exploration of space or the development of new technology? (U.S. investors are already finding that enterprises that formerly produced for the military make excellent partners in terms of employees, access to supplies, technical expertise, etc.)

- Can the U.S. or the U.S. and the U.S.S.R. jointly benefit from the capabilities of agencies of the U.N. as they seek to build new trade relationships with each other and/or jointly in Third-world countries?

In short, instead of quibbling over whether or not to grant the Soviets MFN, almost a non-issue, Congress should seek to define a model to guide the Administration as it tries to transform the bilateral relationship from one that has been primarily hostile with little or no trade into one where the military role will be greatly reduced and trade and economic relations will be a primary component.

Chairman **Rostenkowski**. Mr. Theroux.

STATEMENT OF EUGENE THEROUX, PARTNER, BAKER & McKENZIE, WASHINGTON, DC, AND COCHAIR, AMERICAN BAR ASSOCIATION, SECTION ON INTERNATIONAL LAW AND PRACTICE, COMMITTEE ON SOVIET AND EASTERN EUROPEAN LAW

Mr. **Theroux**. My name is Eugene Theroux. I am a partner in the law firm of Baker & McKenzie. It is a special privilege for me to appear here this morning.

I served on the staff of Representative Hale Boggs of Louisiana when he served as a member of this committee. After Mr. Boggs became majority leader, I accompanied him and Mr. Ford, the minority leader, to China in 1972, before returning to the practice of law. My practice has involved China and the Soviet Union and other Socialist countries since that time.

Yesterday, Mr. Chairman, at this time, I was in Moscow, so can give you a very recent, if not a definitively comprehensive report from the Soviet Union.

My taxi driver, on the way to Sheremetyevo Airport yesterday morning, took a detour in Moscow. It was dark, predawn. Snowing. He said he had something to show me, something special. Traveling up Gorky Street, nearing Pushkin Square, he began to gesture. "Donalds," he said, "Donalds."

There, glowing yellow, red, and orange in the dark predawn, like a just-landed craft from another planet, was the largest McDonald's restaurant on the face of the Earth. That McDonald's opens today, January 31, 1990.

Not far down Gorky Street, nearer to Red Square, a banner in a large storefront window announces that a Pizza Hut restaurant, a joint venture, incidentally, will soon be opened there. Pepsi-Cola kiosks have long been a fixture in Moscow, but there are more of them now.

Our own new Baker & McKenzie law office premises are located so near these locations that we are already describing the location to our clients by reference not only to the statue of Pushkin, but to the McDonald's and Pizza Hut Restaurants.

In another sign of the times, when we reached the airport, my taxi driver twisted his expression into disapproval when I offered rubles in payment of my fare. He asked, instead, for payment in Marlboro cigarettes.

And when I boarded my Aeroflot flight to Washington, I met a young lady in her early twenties. She told me her name: Dana Akanova. She is from Alma Ata, the capital city of the Soviet region of Kazakhstan. Dana offered me a large red apple, brought from Alma Ata, and explained that "Alma" means "apple." She arrived yesterday at Dulles Airport, on her way to enroll at the University of Maryland.

These are some of the small signs of change, Mr. Chairman. But they are among thousands of interesting pieces in the mosaic of the United States-Soviet relationship.

Time magazine, in naming its "Man of the Decade" earlier this year, gave most of the credit for the profound changes in the Soviet Union, and in Eastern Europe, to Mikhail Gorbachev. Our own

Government seems to agree. When, within memory, has an American President made it his stated policy to try to help a Soviet leader to remain in power, to encourage the goals of the General Secretary of the Communist Party of the U.S.S.R.? When has the report that the General Secretary might resign his post, the subject of today's news, precipitated such anxiety in Washington and on Wall Street?

Not surprisingly, the strong winds of change in the Soviet Union and Eastern Europe have begun to fill the sails of hope and expectation among the fleets of United States business. In my prepared testimony today, which I am submitting for the record, I have touched on some of the subjects relating to United States-Soviet commercial relations.

Incidentally, I noticed in this morning's paper the postponement of Secretary of State Baker's trip to Moscow by 1 day will enable him, time permitting I suppose, to attend the February 9 wedding of Susan Eisenhower, President Eisenhower's granddaughter, to one of the Soviet Union's leading scientists, Dr. Roald Sagdeev.

My perspective, as noted in those prepared remarks, is that of a lawyer with 20 years of experience devoted mostly to trade and investment in China and in the U.S.S.R.

Over the weekend, I spent time meeting with officials of the Soviet Far Eastern region of Nakhodka, a special economic zone, and also on plans for the opening of our Baker & McKenzie offices in Moscow, where we have had two lawyers in Moscow over the last year assessing our needs. We expect to have five lawyers in place by the end of the year. So our outlook is optimistic, though cautiously so.

Thank you, Mr. Chairman.

[The statement of Mr. Theroux follows:]

TRADE AND INVESTMENT IN THE SOVIET UNION AND EASTERN EUROPE: OBSERVATIONS ON SOME LEGAL AND PRACTICAL PROBLEMS

Testimony of

Eugene Theroux
Baker & McKenzie
Washington, D.C.

At Hearings Before the

Committee on Ways and Means
U.S. House of Representatives
January 31, 1990

I appreciate the opportunity to present views on the legal aspects of our developing economic relations with the Soviet Union.

My name is Eugene Theroux. I am a partner in the law firm of Baker & McKenzie in Washington, D.C., and I serve as Co-Chair, with Thomas Shillinglaw, Esq. of Corning, Inc., of the Committee on Soviet and Eastern European Law of the Section on International Law and Practice of the American Bar Association. I am before this Committee speaking strictly as an individual, and not on behalf of my Firm, or any client, or the American Bar Association.

Recommendations

Before proceeding to a more general discussion, I would like to summarize very briefly, at the outset, some conclusions and recommendations for the Committee.

Congress cannot be a bystander to the profoundly important events now shaping the Soviet Union and Eastern Europe. United States commercial relations with the USSR and East Europe will be enhanced to the benefit of the American public with the following actions by the Congress:

1. Encouragement to the Executive Branch to proceed promptly with negotiations with the Soviet Union toward the following accords:

   a. A bilateral trade agreement, based on Sections 404 and 405 of the Trade Act of 1974; these sections require that such an agreement contain certain reasonable and prudent provisions, including implementation upon Congressional approval;

   b. A bilateral investment protection treaty, of a kind which we have concluded with several countries and sought with the People's Republic of China, but which for some reason we seem not to have pursued very actively with the Soviet Union;

   c. A bilateral tax treaty.

2. Repeal of the Jackson-Vanik Amendment Section 402 of the Trade Act of 1974, 19 U.S.C. §2432. This amendment effectively denies most-favored-nation tariff treatment on imports from the USSR, and precludes Soviet participation in certain U.S. financial credit and guarantee programs.

3. Repeal of the Stevenson Amendment, Section 613 of the Trade Act of 1974, 19 U.S.C. §2487. This amendment prohibits any agency of the United States (except the Commodity

Credit Corporation) from approving loans, guarantees, insurance or any combination of these for exports to the USSR in amounts over $300 million.

4. Repeal of the Byrd Amendment to the 1974 amendments to the Export-Import Bank Act, 12 U.S.C. §635e(b). This amendment prohibits certain loans or guarantees in amounts exceeding $40 million in connection with research or exploration relating to fossil fuel energy resources in the Soviet Union.

5. Repeal or Revision of the Foreign Assistance Act of 1961, Section 620(f) of which, 22 U.S.C. §2370(f), restricts the Overseas Private Investment Corporation (OPIC) from offering insurance and guarantees for projects in the USSR.

6. Export Administration Act revision to take account of the new realities presented by recent events in the Soviet Union and Eastern Europe, and which realistically addresses U.S. national security concerns.

7. Enactment of Imaginative Legislation designed to encourage and facilitate contacts between and among American citizens, and the citizens of the USSR and East Europe, in areas of art, athletics, drama, education, film, investment, music, science and space, tourism and trade.

Americans have historically taken pride, and justly so, in the boldness of their approach to problem-solving. Today, in the necessarily rapid evolution of our relationships with the Soviet Union and Eastern Europe, we seem unable or unwilling to match the imagination and the energy of the Soviet leader, Mikhail Gorbachev. One indication of our willingness and ability to keep pace with the pace of change will be the manner in which Congress, not the Executive Branch alone, exercises its lawmaking and oversight functions where the Soviet Union and the countries of Eastern Europe are concerned.

Baker & McKenzie

Before I proceed further, it may interest the Committee that Baker & McKenzie, with more than 1500 lawyers in 27 countries on five continents, is the largest law firm in the world. Our Firm, Mr. Chairman, was founded in your great city of Chicago. Chicago remains the location of the largest of our forty six offices. The newest office of our Firm, appropriately in light of the focus of these hearings, is Moscow. We have posted two attorneys in Moscow since January, 1989. We added a third lawyer there earlier this month. With an office in Budapest, we are the only American law firm with an office of its own in East Europe.

More than half of our lawyers are nationals of countries other than the United States, more than half practice outside of the United States, and 35 of our 46 offices are located in foreign jurisdictions.

Background

I am no expert on the Soviet Union, but I have been fortunate in my practice to have become very actively involved in matters relating to the People's Republic of China and the USSR, two countries which have presented very dramatic -- if not always very profitable -- opportunities for my clients. I have had twenty years in a private practice, devoted almost entirely to international commercial transactions and international civil litigation.

For much of the past two decades, more than seventeen years, my work has involved the legal aspects of trade and investment with the People's Republic of China. In all, I have made some 150 trips to China, and I have spent more than five years there in the aggregate. More recently, over the last four years, I have been involved on behalf of clients with business projects in the USSR, in the course of which I have helped establish our Moscow office.

The Soviet Union, East Europe and China

The Soviet Union and the countries of East Europe today offer trade and investment opportunities - and obstacles - comparable to those foreign business has found in China over the past two decades. Comparable, that is, insofar as these are socialist countries grappling with the failure of their economic systems to meet the needs and aspirations of their people, and opening their systems, to some extent, to entice an infusion of capitalism's methods, technologies, markets, equipment and financial resources.

Marxism-Leninism was at least supposed to be successful in the equitable redistribution of goods and services. Its failure in that regard was compounded not only by its failures in productivity across the board, a revelation of the central fallacies of state communism, but by the means through which the leaders forcibly subdued their people. Particularly in the years since the end of World War II, China, the peoples of the USSR, East Europe and China have seen their standards of living fall to the edge of the material abyss, while the populations of the free market countries, including defeated Japan and West Germany, of all places, have enjoyed prosperity and abundance. This fact was evident, most dramatically, in the faces of East Berliners, recent visitors to West Berlin, discovering the huge extent to which their system had robbed them of a chance for the material prosperity enjoyed by their German cousins.

Socialism's Failures Yield Prospects, Problems for Us

The decay of the socialist economies is becoming the compost for conditions in which American companies of all kinds and sizes, with all kinds of products, technologies and services, are lately growing into business discussions, transactions and even joint business ventures, with enterprises in the Soviet Union and the countries of East Europe. In the suddeness of these new opportunities, and the race to take advantage of them, it is easy to overlook how profound are the changes we are witnessing in the world.

Notwithstanding a decided turndown in trade and investment activity following the events of June, 1989 in Tiananmen Square, China has proved to be a generally positive experience for many American firms. But as I have noted, the obstacles to trade and investment found in China have begun to appear in the Soviet Union, in Hungary, in Yugoslavia and in Poland, and they are certain to turn up in East Germany, Czechoslovakia and Romania. These conditions suggest both show the problems -- and, I believe, the promise -- for foreign investment. They include:

Political Uncertainty. The USSR and East Europe, while opening dramatically to trade, and beckoning investment with a growing array of incentives, are in a period of marked political uncertainty. There are some U.S. firms willing to invest notwithstanding the sharp shifts in political power and indications of unstability. In this period, most U.S. companies interested in these new markets are seeking to develop opportunities while limiting to the maximum possible extent the commitment of capital resources.

Weak, Inconvertible Currencies. Lenin believed, it is said, that he could hasten the demise of capitalism by strategems to debauch Western currencies. Today, it is the Soviet Ruble and the East European currencies that are nearly worthless. Soviet hotels will not accept Soviet currency from foreign visitors, the taxi drivers of Moscow, Warsaw and Budapest want payment in Western cigarettes or bars of soap, the black-market money changers are ubiquitous, offering rates of exchange which bear little relationship to officially established rates. So Western companies must face the fact that these countries and their inhabitants, demonstrably needing nearly everything, cannot afford to buy very much, and they must plan their business accordingly.

Inexperienced Management and Labor. If bureacracy is the enemy of efficiency, it is easy to see how socialism has nearly perfected the unproductive enterprise. In just about every single business project in which we have assisted our clients in the Soviet Union, East Europe and China, our side, with its know-how and experience, has found itself able to offer greater production of higher quality with fewer people in a shorter time than has been achievable under socialsim. This is not a particularly surprising phenomenon; it does not get headlines here. But it is a profound indictment of state socialism. This need not be a permanent condition. China's growing ability to achieve productivity is apparent from its ability to dominate many of the world's light manufacturing sectors. Admittedly, this achievement is due in part to China's pre-1949 mercantile traditions, and to the fact that some bankers, factory managers and traders who gained their experience before the revolution remain alive and active today. Some of the East European countries, Marxist stepsons of Moscow only since the end of WWII, will likewise benefit from an ability to draw on entrepreneurial traditions and human resources. The Soviet Union is a different story, however. It has had nearly three quarters of a century's experience with communism, and before that it was in feudalism. It lacks a tradition which will merge easily with foreign entrepreneurship. Among the more discouraging portents as far as U.S. trade and investment in the USSR is concerned, it is a rare American businessman who is not utterly appalled at the lack of a work ethic among managers and workers alike in the Soviet Union. This phenomenon means delay in most phases of business in the USSR today. But, as I have said, this need not be a permanent condition. We need look no further than the Soviet space program, the Soviet Olympic teams, or the Soviet ballet to understand the capacity of the Soviets to excell.

Corruption. Sitting as we are today in a country in which some leaders of our proudest institutions - governemnt, law, religion, medicine and finance, among others - have gone to prison for corrupt activities, we should take care about pointing fingers. I feel it is necessary to note, though, that there are disturbing indications, in the Soviet Union and in some of the countries of East Europe, of a growth in the kind of petty corruption which if unchecked will infect and may destroy many otherwise needed and beneficial projects. The factors I have noted - political instability, currency inconvertibility and inexperienced personnel - contribute to this noxious development.

The Present is Prologue

Four of five years is not a long time, and certainly not a sufficient time, for us to be drawing final conclusions about trade and investment prospects in the Soviet Union. Four of five months observing the revolutionary changes in East Europe tell us nearly nothing about what to expect from these countries as far as busines and trade are concerned. Even after almost twenty years experience in Sino-U.S. commercial relations, many wonder what direction those relations are headed.

Hence, our emerging commercial relations with the USSR, stimulated as they are by President Gorbachev's policies of perestroika and glasnost, are as yet too new for us to be able to draw firm or final conclusions. Aside from leading American firms such as PepsiCo, Inc., among a few others, which pioneered business with the Soviet Union and which continues to enjoy expanding commercial relationships there, only a comparative handful of American businesses have sent representatives to the USSR to explore possibilities seriously, fewer have negotiations under way, fewer still have concluded business, and only a handful have entered into joint ventures with Soviet partners.

Interest is strong, nonetheless. In July of 1988 and 1989, I chaired two-day conferences in New York, sponsored by the Practising Law institute, on the subject "Legal and Practical Aspects of Doing Business with the Soviet Union." These programs drew in excess of representatives of 125 companies. Conferences on this general subject are proliferating, and probably not a week goes by without a program on this subject in an American city. Our Firm's Dallas office has organized a half-day program on the USSR on February 7, expecting about 25 companies. We are over now subscribed with 150 registrants. The ABA is working with People to People's Citizens Ambassador Program on a law conference in the USSR which is expected to bring upwards of 1500 American lawyers to Moscow during September 19-21, 1990. A few months from now, in May, the US-USSR Trade and Economic Council will conduct its annual membership meeting in Moscow, and very likely a chartered Boeing 747 will not be large enough to carry all the business leaders from among the Council's U.S. corporate members who will participate.

Predictions at this early ~~stage of~~ the Gorbachev era, as with any prognostications founded on assumptions based on insubstantial data, may turn out to be quite wrong. In this regard, I had a personal experience with China that may be instructive in the present context.

In June, 1972, about three months after President Nixon's historic trip to China, I had the honor, as Special Counsel to the Joint Economic Committee of the Congress, to accompany to China the leaders of the House of Representatives, the late Majority Leader Hale Boggs -- once the second-ranking majority member of this distinguished Committee -- and Minority Leader Gerald Ford. On our return, Mr. Boggs and Mr. Ford presented to the House a report entitled "Impressions of the New China" (House Doc. No. 92-337, 92d Congress, 2d session). That report contains the statement that "[t]he exchange of goods, like the exchange of people, can be a bridge to better mutual understanding and improved political relations." While that has proved to be the case in China, our trade with that country has evolved dramatically in ways we did not foresee. On that visit, we were told that in foreign economic relations there were "forbidden zones." China, we were advised, would never import foreign consumer products, would never permit foreign participation in exploration or development of China's natural resources, and would never seek foreign capital. In the years since 1972, when such policies appeared to be unchangeable verities, I have personally been involved with the Chinese in projects in every one of these once "forbidden" areas.

Today the USSR beckons American business as did China in 1972. The Soviet Union offers now, as China offered then, a "new frontier" for trade and investment -- opportunities unique, uncertain, alluring, potentially large and profitable, at once the picture of straightforward simplicity and bewildering complexity. As with China then, some business observers are euphorically optimistic, others darkly pessimistic, about business with the USSR, and there are those with ideological or political axes to grind who seek to frustrate or burden or economic relations with obstructive policies, laws and regulations. For China, where trade with the United States is concerned, all but the dreamiest optimists of the early 70s were off the mark, the pessimists were wrong, and the obstructionists became irrelevant. Events in East Europe, and in the USSR, suggest that the present constriction of China's "Open Policy" can only be temporary.

Even optimistic forecasts did not anticipate the remarkable achievements that American firms, both large and small, have made with Chinese enterprises, as buyers, suppliers, joint venture partners and exchangers of technology and know-how. To be sure, there are differences between the China of 1972 and the Soviet Union and East Europe of 1990. Most obviously, the USSR rivals the United States globally in the most sobering aspects. It remains our most powerful potential military adversary, and we cannot overlook that our state relations with the Soviets have proved difficult and even dangerous. A strong case can be made that the USSR's self-evident domestic difficulties lessen the Soviet danger to the United States, and that we should not allow, much less encourage, U.S. firms to supply needed capital, goods and know-how to struggling Soviet enterprises. But that argument does not persuade me. U.S.-China economic relations since 1972 have proved a very important contributor to stability, understanding and peace, and I have little doubt and much hope that U.S.-USSR economic relations are poised to do the same.

Now, let me turn to the more specific subjects at hand.

1. Joint Ventures

In January, 1987, the Soviet Union promulgated a law permitting Soviet enterprises to enter into equity joint ventures with foreign firms. The joint enterprise law, and subsequent implementing regulations and decrees, have attracted considerable interest from abroad, including American firms. The joint venture law is perceived as a potentially important means of gaining access to the Soviet domestic market for foreign goods and services, and the law is also seen as a means for establishing a Soviet manufacturing base for serving third-country markets.

Soviet enterprises have embraced the joint venture concept at least as readily as foreign firms. They recognize the potential of a joint venture, in the language of Article 3 of the law, to "satisfy more fully domestic requirements for certain types of manufactured products, raw materials and foodstuffs." They can also appreciate the importance of attracting foreign capital, advanced equipment and technologies, and management expertise, to invigorate the Soviet industrial, agricultural and service sectors, and to conserve foreign exchange through import substitution, all goals of the joint venture law.

Both sides in a joint venture should recognize early, however, that among the hurdles normally to be anticipated in bringing such a venture into being is one in particular that has proved enormously problematic in soft currency economies like the USSR: that is, the foreign party will normally seek profits in hard currency, while sales or services to the domestic market of course yield only soft currency proceeds. Foreign firms are encouraged by Article 32 of the joint venture law, which provides that foreign partners are "guaranteed that amounts due to them as their share in distributed profits of the joint venture are transferable abroad in foreign currency." But that guarantee is substantially qualified by Article 25 of the Same law, which States that all foreign currency expenditures of the joint venture, "including the transfer of profits . . . shall be covered by proceeds from the sales of the joint venture's products on foreign markets." This limitation, reflecting a primary Soviet intention that joint ventures earn foreign exchange through exports, presents obvious problems for any foreign firm whose major goal is the USSR domestic market.

This "foreign exchange balance" dilemma still plagues joint ventures in China more than a decade after the PRC enacted its joint venture law. It reflects the the reality that in many instances foreign firms and their prospective Chinese partners, each believing a joint venture will meet their objectives, in fact, have quite different goals, and are talking past each other. This problem has produced the colorful adage that a joint venture in which the parties' objectives diverge is one in which "the partners are sleeping in the same bed, but dreaming different dreams."

Any firm contemplating a joint venture in the Soviet Union, and a small firm in particular, should be aware of the following facts:

1. A joint venture between two U.S. parties, operating in the U.S., where the parties speak a common language, deal in familiar traditions and operate in a commonly understood legal framework, can be a difficult proposition. A joint venture between a U.S. and a Canadian party -- different traditions and law -- will be more difficult. A U.S.-Mexican joint venture -- more radical differences of culture, tradition, law and language, and greater distance -- will be still more difficult. So obviously, a joint enterprise between a U.S. and a Soviet joint venture presents formidable difficulties.

2. Joint venturing in the USSR is an expensive proposition, likely to be beyond the reach of small U.S. firms. Soviet enterprises themselves often express a desire to work with small and medium-sized U.S. firms. Nevertheless, the opportunities for these firms will be somewhat less than for large firms. The primary reason is cost. Even large American corporations are daunted by the expense associated with pursuing a possible venture in the USSR. The cost of executive time spent in the USSR, and in fashioning and reviewing proposals at home are alone substantial, not to mention the cost of travel and communication between the U.S. and the Soviet Union, which can be considerable. And this does not include costs associated with operating a venture, usually with some home-office managerial and technical personnel, posted in the Soviet Union over a period of time. A second factor is that Soviets consider the resources and staying power of potential joint venture partners, and smaller firms may face a higher burden in demonstrating to the Soviets that they are suitable long term partners.

3. Perhaps the best opportunities for American business in the early stages of the newly warming U.S.-USSR commercial relationship will be as suppliers of goods and services, or subcontractors, to joint ventures in which larger U.S. (or other foreign) corporations are in a partnership with a Soviet enterprise.

4. Another potential opportunity, perhaps better suited to smaller businesses, lies in the rapid rise of privately owned cooperatives in the USSR, stimulated by a new law on cooperatives which went into effect in July of this year. These businesses may be granted foreign trade rights, including the right to enter into joint ventures with Western firms. They have already organized into associations of cooperatives at local and regional levels, and soon will have a national organization. As the cooperative movement develops, joint venture opportunities and other trade opportunities may develop for small and medium-sized U.S. businesses.

5. The most promising areas for U.S.-Soviet joint ventures, it seems to me, will be in areas related to:

tourism, such as hotels, transportation, food service and telecommunications;

manufacturing for export, where U.S. equipment and know-how can produce new or improved and competitively priced products for the international market;

consumer goods for the Soviet market, providing the Soviet Government applies its imagination to the convertibility of the ruble and the availability of goods or commodities for barter, in exchage for the array of consumer articles now absent from Soviet shelves;

agriculture, particularly insofar as projects may contribute to more efficient production, delivery, processing and marketing of livestock, poultry, vegetables, fruits and grains;

fisheries, where U.S. know-how in acquaculture, processing and marketing may mesh with the enormous fisheries potentials in the USSR;

2. The Legal and Policy Framework in the USSR

The Soviet legal and policy framework is in a transition stage. Until recently, the USSR has not had a legal and policy framework to nurture its own enterprises, much less one hospitable to foreign firms. The inefficiencies and bureaucracies which appear to have stymied centrally planned economies throughout the world are, led to the policies of glasnost and perestroika. Perestroika is designed to make the Soviet economy function principally on the basis of market forces. This necessitates a vast restructuring of the production, supply, distribution and pricing systems, which is only partly underway. Glasnost, the openness intended to foster the uninhibited discussion of problems and exchange of information, is a complementary concept essential to the success of perestroika.

These new policies, if continued, will make the Soviet Union more like us in important respects. A stronger basis for mutual understanding and mutual interest will evolve, which will place U.S.-Soviet relations on a stable basis that is more secure than the detente of the 1970s.

While the potential foreign investor is lured to the USSR with an attractive legal framework, and a positive Soviet national leadership rhetoric to match, it is too soon to tell if such laws and policies, and the enterprises, innovations and efficiencies they are intended to create, can escape suffocation by the bureaucratic inertia which has accumulated over the years. A joke current in Moscow tells of the bureaucrat who complains that perestroika has woefully burdened his department, with reductions in personnel and requirements that the staff do the work of ten men. "Thankfully it may not be impossible," he says, "since we are still left with a staff of fifteen." This problem was candidly acknowledged not long ago by a Soviet official of the Soviet-French-Italian joint venture "Interkvadro" who said, according to Izvestia, that "the system of administration through commands which has ruled for many decades in our economy has made people unaccustomed to displaying initiative, independence, and enterprise -- all the qualities which you simply cannot do without in a new undertaking and which are now lacking most of all."

The Soviets are sensitive to these problems as they seek to attract foreign firms to do business in the USSR. Recently, for example, the Soviet authorities (the USSR Council of Ministers and State Foreign Economic Commission) have encouraged the formation of a "Joint Enterprise Association," composed of representatives of joint ventures, to become the "defender of the interests of joint enterprises."

Another Soviet initiative which holds important potential for fostering trade and investment is the USSR's evident drive to establish special economic zones. These zones, where special conditions of investment, development and law apply, have proven successful in nurturing major economic successes in other countries. Among the more intriguing and ambitious of these zones is one planned for the city of Nakhodka, southeast of Vladivostok, on the Sea of Japan, and proximate to Japan, China, Korea and other countries -- including our own, of course, in the wide, dynamic Pacific region.

3. The Legal and Policy Framework in the United States

No discussion of the U.S. trade and investment in the USSR can be complete without reference to the great unmet expectations of the 1970s period of detente, and the never-ratified U.S.-Soviet Trade Agreement of 1972.

The high hopes of detente for increased trade, and the 1972 trade agreement in particular, were in this observer's view dashed less by Soviet misbehavior than by anti-Soviet forces here who found a Congressional majority willing to give expression to their causes in the Jackson-Vanik amendment. This is particularly evident when one takes as a guide the lack of linkage that the United States imposes between human rights and trade with most other countries. I want to make clear at the outset that I do fail to see why the Soviet Union, in its own interest if not as a response to external pressures, was for so long unwilling to facilitate the prompt departure of any national who has applied to leave the USSR. Be that as it may, the policy question we face is no longer the extent to which the U.S. Government may be justified or effective in pressuring the Soviets to facilitate emigration, and whether the particular linkage of the Jackson-Vanik amendment is the appropriate means. I believe that this particular linkage has been ineffective, that it ill served U.S. businesses and American consumers alike. I think it is self-evident that it was counterproductive in the overall U.S.-Soviet relationship. It is also distressing to note the cynicism with which the State of Israel is manipulating the Soviet Jews who are now emigrating in growing numbers from the USSR, settling them in territories Israel illegally occupies, and to note the brazenness which Israel now asks the United States to finance that cynicism.

My dispute with the Jackson-Vanik amendment stems in part from the example of China. U.S.-China relations were frozen for some twenty years, with an absolute embargo on trade, between the Korean War and Nixon's 1972 China visit, largely because Congress perceived itself impotent to deal with the power of the "China Lobby." Who knows what good might have come to the United States out of earlier common-sense relations with the People's Republic of China? Vietnam, the most wrenching American military conflict of this century, might have been avoided or brought to an earlier conclusion.

Now, Congress is equally prone to be captive -- let us face facts -- to a lobby whose thirst for Soviet political concessions may be unquenchable. As long as Congress finds itself incapable of responding to new and positive Soviet realities, we will be as unable to respond to opportunities to advance our national interest with the Soviet Union as we were with the PRC when our misguided policy was to "contain China." To be specific, I put the Slepak Principles in that category of initiatives which are, at best, misguided.

It is said by some that most-favored-nation tariff treatment accorded to imports from the USSR, and the availability of export credits and OPIC insurance to U.S. exporters interested in the USSR, would not make a significant difference in the volume of U.S.-Soviet trade. At least initially, maybe so, but the economic reforms in the Soviet Union promise an increase in exportable Soviet goods. To the extent that the Soviets are denied U.S. dollars by this restriction on exports to the United States, Soviets lack the currency needed to purchase goods from U.S. businesses, thus hurting these businesses' ability to export to the Soviet Union. Further, ironically, the Jackson-Vanik amendment penalizes exports to the United States by joint ventures involving U.S. participants.

It is pointed out by others that the failure of the U.S. to ratify the 1972 trade agreement with the Soviet Union absolves the USSR from obligations contained in that agreement to make substantial payments to the U.S. treasury for amounts past due under the Lend-Lease program. This is so, but the particular clauses in the trade agreement, and their evisceration by Jackson-Vanik, are less important than the fact that economic relations with the USSR should not be subject to such linkages.

The Soviets do little to advance their interests in the United States when they imply that a condition precedent to improved relations might be more humane U.S. policies toward our minorities, our unemployed and our homeless. We rightly regard this as unacceptable interference in our domestic affairs by meddlers with ulterior motives, even though we acknowledge such shortcomings in our society. Soviet irritation with similar criticisms from elements in this country is likewise understandable. In our trade and investment relations with the USSR, Congress should resist the crusades of single-issue movements, however well-intentioned.

Should the U.S. Government regulate trade and investment by U.S. parties in the Soviet Union? Of course. Our controls on strategic exports, for example, are essential. But we should no more tie trade benefits such as tariff treatment and export credits to Soviet domestic policies than we would deny such benefits to other countries -- there are many with whom we trade -- whose domestic policies offend us. To the extent that emigration is a concern of the United States, it is a political problem that should be dealt with on the political level. Emigration has risen and fallen with the ups and downs of the U.S.-Soviet political relationship and has been affected only marginally, if at all, by the Jackson-Vanik amendment. I very much doubt that increased emigration will be facilitated by demands made belligerently and publicly. The better approach is to leave commercial relationships alone and obtain progress through quiet diplomacy and subtle political pressure.

4. Appropriate Policies in the USSR and the United States

To further encourage all business relationships with the United States, the Soviets need to continue to implement the reforms of perestroika and glasnost. As the Soviet economy begins to operate on a market-like basis, trade opportunities for businesses similar to those in other countries will appear. As noted at the outset, U.S. policy should be to encourage these reforms, and to respond to them. A good start would be to eliminate the Jackson-Vanik amendment altogether.

A second Soviet initiative that needs to be fostered is an exercise in the imagination by both Governments to find ways to facilitate communication and the exchange of information between their business entities. This could be done partly in the context of the U.S.-U.S.S.R. Joint Commercial Commission. One concrete aspect of this might be to facilitate the development of sector-specific trade exhibitions for small and medium-sized businesses in the Soviet Union. All but the largest businesses often have difficulty in identifying and meeting with potential customers abroad, and the USSR presents special problems of access.

A third measure of long-term importance is the exchange of human resources. Currently, there are about 35,000 exchange students from the People's Republic of China in the United States. Most of them study in business, economics and technical areas, and most will eventually return to China to work in the development of China's economy. This exchange has been an important aspect of the improved trade relationship between the Untied States and China. Although the nature of the U.S.-Soviet strategic relationship may require some limitations on a similar program with the Soviet Union, a broader educational exchange, specifically including an graduate schools of business and law, would be helpful in improving the U.S.-trading relationship at all levels. Not to be forgotten are the other, non-business areas of cooperation and exchanges which the two governmnts should seek to foster, in the arts, in the sciences, and in all the many ways that people can be encouraged to come together in recognition and celebration of their common humanity.

5. Lessons Learned from Doing Business with the USSR

Broadly speaking, I have learned the following from doing business with the Soviets over the last couple of years:

1. They are serious, in most instances at least as serious than their American negotiating partners, in pursuing joint venture agreements. This means, in some instances, that they are eager for joint ventures in projects that do not lend themselves to that form of doing business, and which may be more suitable to buy-sell or license agreements.

2. They are not sufficiently understanding, owing no doubt to the kind of society in which they live, of the fact that American firms do not give serious consideration to a possible joint venture unless it offers a genuine prospect of profit within a reasonable time. An unfamiliarity with establishing true costs of production, and pricing accordingly, exacerbates this problem.

3. They have not fully resolved, in their minds or in policy, how it can be that the fruits of a joint venture -- its products or services - can both benefit the USSR domestic market and earn foreign exchange; if foreign capital, equipment, know-how, management and technical expertise are to help improve the standard of living in the Soviet Union, the joint venture's products should reach the Soviet market, but since the process from sales on the Soviet market would be in nonconvertible rubles in the great majority of cases, most joint ventures will be forced to look to the international market.

4. At least at the outset, they often lack an appreciation of the time it will take, in most instances, for a joint venture to proceed from the proposal stage through a feasibility study toward a contract to start-up and finally to operation.

5. Notwithstanding the foregoing points, which to some degree are present in all international business in any event, the U.S. business representative finds in the Soviet Union today a potential business partner who is willing to go more than half way to achieve a mutual rewarding result. That the Soviet side offers enthusiasm, a surprising ability to conduct negotiations in the English language, willingness to work toward a shared goal, and an evolving legal and policy framework hospitable to business cooperation, should be enough to attract many American firms to the negotiating table , at least.

- END -

Chairman **Rostenkowski**. Thank you. You gave us so much color.

Mr. **Theroux**. I don't want to cheat the other members of the panel in time.

Chairman **Rostenkowski**. Mr. Hammer.

STATEMENT OF RICHARD M. HAMMER, NATIONAL DIRECTOR, INTERNATIONAL TAX SERVICES, PRICE WATERHOUSE, AND CHAIRMAN, TAX COMMITTEE, U.S. COUNCIL FOR INTERNATIONAL BUSINESS

Mr. **Hammer**. Mr. Chairman, my name is Richard M. Hammer, a partner of the accounting firm of Price Waterhouse, and I serve as national director for the International Tax Services. My firm opened an office in Russia last month, and we have had an office in Budapest for over a year now, and it is flourishing.

I appreciate addressing this distinguished group, and as a tax professional, on the way in which our U.S. tax treaty program can be used to encourage increased trade by U.S. multinationals in Eastern Europe.

Mr. Chairman, I am well aware that the House of Representatives and that this committee do not exercise formal jurisdiction over the tax treaty process. But I know, sir, of your particular interest in the subject.

I believe that a revision of our treaty with the U.S.S.R. as well as entering into treaties with those Eastern European countries and which we do not now have one should be a part of the overall U.S. policy to encourage our business to participate in the process of democratization in Eastern Europe.

I believe this committee can have a strong influence on bringing this result about. Our Government has been criticized for its failure to match the financial commitments made by several of our Western European allies to the Soviet Union and to countries throughout the Eastern bloc in their struggle to break with their past.

American companies have demonstrated a similar reluctance, certainly, when compared to their competitors in the EC and Japan, to make private investments in the Eastern European nations.

There are many reasons why our Government may be justified in its caution. There are also reasons why American business should approach ventures in the Eastern bloc with a critical eye. Investments in the region are not for the faint-hearted.

Large or perhaps even small profits will not appear overnight. The lack of convertible currencies make repatriation of any local currency profits problematic. The absence of wholesale markets in these countries often makes the running of business an exercise in futility.

Yet, for all that, some Western investment is indeed being made and investment will continue as long as the process of reform continues.

One way in which to help encourage private investment is to extend our tax treaty program to those Eastern European countries with whom we do not now have treaties. At present, we have treaties only with the U.S.S.R., Poland, Hungary, and Romania.

A principal objective of any bilateral tax treaty program is to avoid the threat of double taxation as an impediment to international trade. But treaties can also be used affirmatively to encourage trade between the two countries.

Most of our treaties provide for reduced withholding rates for dividends received by home country shareholders from corporations formed in the treaty jurisdiction. Our treaties also provide for zero or low-rate withholding taxes to residents of the other country.

By eliminating or reducing these withholding taxes on income flows, cross-border investment decisions are more likely to be based on pure business and economic considerations, which is what we want.

Our existing treaties with the three European countries other than Russia are models to build upon. They are based on the DECD and U.S. Treasury model treaties. They provide for reduced withholding rates on dividend flows and reduced or no withholding taxes on royalties and interest.

While these treaties benefit both sides, in fact U.S. investors will reap most of the tax advantages for the foreseeable future. This is because, as is obvious, I think the flow of investment capital promises to be pretty distinctly one-sided, from the United States.

So, the reduction or elimination of these border taxes will benefit the U.S. party.

As to our treaty with the U.S.S.R., it may be the most limited and narrow of all our treaties. When it was negotiated and signed in 1973, many provisions regarding the tax treatment of private investors which commonly appear in other treaties were not included because they would have been inappropriate in the Soviet context given the substantial differences between our two systems.

Of utmost importance, the treaty contains no section dealing with withholding tax on dividends received from Soviet enterprises. The absence of a provision to reduce withholding tax on dividends was unimportant until 1987. Before then, most business in the U.S.S.R. was, and continues to be, conducted by State enterprises whose net income was transferred to the State budget; the Soviet Union did not really have anything approaching a privately owned corporation.

However, in 1987, the U.S.S.R. adopted laws to attract foreign investment through joint ventures with Soviet entities, principally State enterprises and ministries.

The Soviet legislation provides for a 30-percent tax on a joint venture's earnings, with a further 20-percent tax on profits remitted to the foreign investor. The tax on distributed profits treats it as such for purposes of its tax treaties with other countries. The fact that the current U.S.-U.S.S.R. treaty is silent on the treatment of distributions from joint ventures puts a United States investor in the joint venture at a competitive disadvantage with investors from countries such as the United Kingdom, that have a more favorable treaty with the Soviet Union.

From the perspective of a U.S. corporation that becomes a member of a joint venture, the 20-percent withholding tax, unrelieved by treaty, increases the corporation's effective tax rate on its share of the joint venture's earnings to 44 percent. Because of changes made by the Tax Reform Act of 1986 in lowering corporate income tax rates and tightening the foreign tax credit rules, many U.S. multinationals are today in an excess foreign tax credit position. As a result, foreign investments become progressively more unattractive as the effective foreign tax rate on the investment exceeds 34 percent.

In short, there is a substantial tax barrier to United States investment in Soviet joint ventures. To reduce or avoid the 20 percent withholding tax, most United States companies consider routing their investment through corporations in third countries that have favorable treaties with both the United States and the U.S.S.R.

New treaties with the Soviet Union and the Eastern bloc would provide a needed affirmation of the tax treaty process.

As has been mentioned by previous panelists, they have been routed to U.S. parent corporations through third countries which do have treaties with the U.S.S.R. This is known as treaty shopping, a term which has been coined in this country. Revision of our income tax treaty with the Soviet Union would eliminate the necessity for American companies to treaty shop, a concept that has long been anathema to Congress, this committee, and the Internal Revenue Service. More importantly, by opening negotiations with the Soviet Union to modernize our treaty, we can breathe new life into the treaty program. By reaching agreement on a new treaty, we can remove an often expensive barrier in American investment in the U.S.S.R.

In closing, I urge the committee to encourage the Treasury Department to initiate discussions aimed at revising our current tax treaty with the Soviet Union and opening tax treaty negotiations with other Eastern European countries. Such actions, which should be given a high priority, will constitute an important element of a program to increase trade between our nation and that part of the world.

[The statement of Mr. Hammer follows:]

STATEMENT OF RICHARD M. HAMMER
NATIONAL DIRECTOR OF INTERNATIONAL TAX SERVICES
PRICE WATERHOUSE
IN HEARINGS BEFORE THE COMMITTEE ON WAYS AND MEANS
ON U.S. TRADE RELATIONSHIPS WITH THE SOVIET UNION
AND EASTERN EUROPE

JANUARY 31, 1990

Mr. Chairman and Members of the Committee:

My name is Richard M. Hammer. I am National Director of International Tax Services for Price Waterhouse. I am the immediate past President of the International Fiscal Association, and also serve as Chairman of the Tax Committee of the U.S. Council for International Business.

I am grateful for the opportunity today to address this distinguished panel on the ways in which the U.S. tax treaty program can be used to encourage increased trade between our country, the Soviet Union, and Eastern Europe.

The Tax Treaty Process

I am well aware that the House of Representatives and this Committee do not exercise formal jurisdiction over the tax treaty process. Nevertheless, our income tax treaties with foreign countries have been of interest to the Committee for many years. For the most part, I think that attention has been unfortunate, since generally it has resulted in legislation that overrides treaty provisions on an "across the board" basis - provisions that were mutually beneficial at the time the treaties were signed, and provisions that our treaty partners, bargaining in good faith, thought they could rely upon until the treaty was renegotiated or terminated.

As an international tax practitioner for more than 30 years and an ardent advocate of the treaty program, I believe these legislative overrides have unnecessarily strained relations with our major trading partners. This phenomena, along with the continuous stream of major tax legislation we have endured in recent years, has severely weakened one of the principal pillars of a fair and equitable tax system -- predictability of treatment. It is axiomatic that if a foreign investor is uncertain about the tax impact of a planned investment in this country, it is less likely that the investment will be made.

I think the important subject matter of this hearing permits a more balanced focus on the positive value of tax treaties to the United States. I strongly believe that taking a fresh look at our income tax agreement with the Soviet Union, as well as making a concerted effort to enter into new treaties with those Eastern European countries with whom we do not currently have agreements, should be part of our overall policy to encourage democratic and market-oriented change in the East.

The Pitfalls of Investment in Eastern Europe and the U.S.S.R.

Our government has been roundly criticized for its failure to match the financial commitments made by several of our Western European allies to the Soviet Union and to countries throughout the Eastern Bloc who are struggling to break free of their ideological past and their centrally planned economies. American companies have demonstrated a similar reluctance, certainly when compared to their competitors in the EEC and Japan, to make private investments in the Soviet Union and Eastern Europe.

There are many reasons why our government's caution may be justified. There are even more reasons why American business should approach ventures in the East with a critical eye.

Investments in the region are not for the faint-hearted, large (or even small) profits will not appear overnight, the lack of convertible currencies throughout the region makes repatriation of any profits problematic, and the absence of wholesale markets in these countries often makes the day-to-day conduct of a business an exercise in futility. Yet, for all that, some Western investment is being made, and investment will continue as long as the process of reform continues.

In the case of Eastern Europe, the critical question for many is not whether the United States should help the process of change, but how and how much? Some have called for assistance in the form of a 1990's equivalent of the Marshall Plan, but our own budget crisis makes that an unlikely course to be followed, at least unilaterally. In the case of the Soviet Union, there is less unanimity of opinion on whether or not we should help at all. For his part, the President has made clear his desire to see perestroika - economic reform - move forward in the U.S.S.R.

Government Action is Required

Without action by our government on a number of fronts, substantial investment in the Soviet Union and Eastern Europe by the U.S. private sector is unlikely in the current environment. In part this is because our own companies are unable to fully exploit the competitive advantage they enjoy in many high technology areas by reason of restrictions on the export to the region of goods in that sector. However, in recent days it appears that some progress is being made on relaxing these restrictions.

I believe we should facilitate increased trade between our country and the Soviet Union as well as the other countries of Eastern Europe. I also believe it will be the private sector's willingness to invest its own capital that, ultimately, will prove most significant.

Tax Treaties Can Eliminate a Barrier to U.S. Investment in the Region

One way in which private investment can be encouraged is to extend our tax treaty program to those countries in Eastern Europe with whom we do not have treaties. At present, we have income tax conventions with the U.S.S.R., Poland, Hungary and Romania. I understand we have had preliminary negotiations with Yugoslavia, but that there has been little activity on that front since 1987.

A principal objective of our tax treaty program is to remove the threat of double taxation as an impediment to international trade. On a bilateral basis, treaties can also be affirmatively used to encourage trade between the two countries. (This, in fact, was one of the primary reasons we entered into an income tax treaty with the People's Republic of China in 1984.) Most of our treaties provide for reduced withholding rates for dividends received by home country shareholders from corporations formed in the other jurisdiction. In addition, our treaties frequently provide for zero withholding tax for payments of interest and royalties to residents of the other country. By eliminating or reducing withholding taxes on these income flows, cross-border investment decisions are more likely to be based on business and economic considerations.

Our existing treaties with three Eastern European countries (other than the U.S.S.R.) are models to build upon. By and large, they are based on model treaties developed by the Treasury Department and the OECD (Organization for Economic Cooperation and Development). They provide for reduced withholding rates on dividends (10 or 15 percent for portfolio dividends, and 5 or 10 percent for substantial holdings), and reduced (10 percent) or no (in the case of Hungary and Poland) withholding tax on interest.

For royalties, the Hungarian treaty completely eliminates withholding tax, and the Polish and Romanian treaties reduce the rates to 10 or 15 percent.

While these treaties nominally benefit both sides, in fact U.S. investors will reap most of the advantages for the foreseeable future. This is because the flow of investment capital will be distinctly one-sided (i.e., from the U.S.). Thus, the reduction or elimination of foreign withholding tax will benefit the U.S. party and therefore encourage its investment.

Revision of the Soviet Treaty

Our treaty with the Soviet Union may be the most limited and narrow of all our treaties. Signed in 1973, negotiations began out of concerns expressed by the Soviet Union on the imposition of U.S. withholding tax on royalties from a license of a Russian invention used in this country. Because of the substantial differences between our economic systems, many common provisions in our other treaties governing the tax treatment of private sector investors would have been inappropriate in the Soviet context. Accordingly, the resulting treaty contained no provision for reducing withholding tax on dividends received from Soviet enterprises. It did, however, contain a limited exemption from withholding tax for interest paid to U.S. investors on funds supplied to finance trade between the two countries. It also eliminated withholding tax for royalties paid to residents of the home country for the license of intangibles in the other country.

The absence of a provision to reduce withholding tax on dividends was unimportant, until 1987. Before then, most business in the U.S.S.R. was (and continues to be) conducted by State enterprises whose net income was transferred to the State budget; the Soviet Union did not really have anything approaching a privately-owned corporation. However, in 1987, the U.S.S.R. adopted laws to attract foreign investment through joint ventures with Soviet entities (principally State enterprises and ministries).

Importance of an Article Reducing Tax on Dividends to U.S. Investors

The Soviet legislation provides for a 30 percent tax on a joint venture's earnings, with a further 20 percent tax on profits remitted to the foreign investor. The tax on distributed profits is equivalent to a dividend withholding tax, and the Soviet Union treats it as such for purposes of its tax treaties with other countries. The fact that the current U.S./U.S.S.R. treaty is silent on the treatment of distributions from joint ventures puts a U.S. investor in the joint venture at a competitive disadvantage with investors from countries (such as the United Kingdom) that have a more favorable treaty with the Soviet Union.

From the perspective of a U.S. corporation that becomes a member of joint venture, the 20 percent withholding tax, unrelieved by treaty, increases the corporation's effective tax rate on its share of the joint venture's earnings to 44 percent. Because of changes made by the Tax Reform Act of 1986 in lowering corporate income tax rates and tightening the foreign tax credit rules, many U.S. multinationals are today in an excess foreign tax credit position. As a result, foreign investments become progressively more unattractive as the effective foreign tax rate on the investment exceeds 34 percent.

In short, there is a substantial tax barrier to U.S. investment in Soviet joint ventures. To reduce (or avoid) the 20 percent withholding tax, most U.S. companies consider routing their investment through corporations in third countries that have favorable treaties with both the U.S. And the U.S.S.R.

New Treaties With the Soviet Union and the Eastern Bloc Would Provide a Needed Affirmation of the Tax Treaty Process

Revision of our income tax treaty with the Soviet Union would eliminate the necessity for American companies to "treaty shop", a concept that has long been anathema to Congress, this Committee, and the Internal Revenue Service. More importantly, by opening negotiations with the Soviet Union to modernize our treaty, we can breathe new life into the treaty program. By reaching agreement on a new treaty we can remove an often expensive barrier to American investment in the U.S.S.R.

In closing, I urge the Committee to encourage the Treasury Department to initiate discussions aimed at revising our current tax treaty with the Soviet Union and opening tax treaty negotiations with other Eastern European countries. Such actions, which should be given a high priority, will constitute an important element of a program to increase trade between our nation and that part of the world.

Chairman **Rostenkowski**. Thank you, Mr. Hammer.

I noted that several of you have pointed out that you opened law offices in Russia. Have you opened them exclusively in Russia? Have you done anything in Poland or any other Eastern bloc country?

Mr. **Theroux**. We opened our first office in the great city of Chicago.

Chairman **Rostenkowski**. There are a lot of Poles in Chicago.

Mr. **Theroux**. We got an early start there. Chicago remains our largest office. I think we are the only American law firm with an office in East Europe, an office in Budapest which is a flourishing office.

Chairman **Rostenkowski**. How long has it been over——

Mr. **Theroux**. It has been there over a year. It is a very busy office. In Moscow, there are other firms with offices. We have had two lawyers there for just over a year. The volume of work is so great that we have taken new space. We are now fully outfitted with telecopiers, personal computers, laser printers—all shipped within the framework of the Export Administration Act, I might add.

We expect to have five lawyers, four American lawyers and one British lawyer, in place by the end of this year.

Chairman **Rostenkowski**. How about you, sir?

Mr. **Hammer**. Price Waterhouse, an accounting firm, has had an office in Budapest well over a year. It is an office of about 40 accountants servicing inflowing investments from the West and getting some work from some of the local joint investors. That is a real growing program.

The Moscow situation has been a little more difficult. We opened in December 1989. It is relatively low-key. There are two accountants who speak the language but are from the West. We are trying to staff up with locals.

In London we have people who operated in the Eastern European territories. As events develop, we will undoubtedly open offices in these other countries, as conditions warrant.

Ms. **Carey**. We have an office in Moscow we have had open for about a year now. In the East European countries where we are also active, we have organizations where we have cooperative ties or affiliations which are local, not American. But the business is unquestionably exploding in all those places.

Chairman **Rostenkowski**. Well, making a judgment about flourishing law firms and accounting firms in both countries, I should imagine that is so. I made the observation earlier that in my exchanges with members in government and Eastern Europe, they thirst for the American ingenuity and presence. And truly, as opposed to their neighbors to the West. As Mr. Gibbons and I have made observations earlier, I just hope that we don't miss this opportunity because I think that this is something that will have dividends beyond our imagination in the future for continued peace in the world.

Mr. Gibbons.

Mr. **Gibbons**. The chairman and I agree 110 percent on that. I want to commend you all and the rest of the private sector for the vigorousness and ability that you have had to get out there and get established and get going. I didn't know how pervasive all this was until I started traveling with my chamber of commerce and got into some of these private offices around the world.

I regret that I had not done it sooner because I have learned a lot, because I am now able to contact the lawyers and accountants and others that never got included in my State Department-guided tour of the rest of the world. I didn't realize how far behind our Government is, in backing our businesspeople.

If we just cut you all loose you would create miracles. I don't know when we are going to learn that. You are way ahead of our Government. I thank you personally for coming up and telling us about what you are doing. I applaud you for doing it and I hope one day we have enough sense to catch up with you.

Mr. **Levin**. I very much share your sentiment. Let me ask, are there law firms from other countries in Moscow, for example, are there any firms from West Germany or from England?

Ms. **Carey**. The lawyers are traveling there a lot but I don't believe they are opening the offices. It is closer for them. They can get there in 2 or 4 hours. They are not as aggressive as American law firms generally, I think.

Mr. **Theroux**. We are trying to jump ahead of that possibility by putting our own Canadian and German in Moscow and they will join the British and American lawyers that we already have there. I expect they will be there in due course.

Mr. **Levin**. Thank you.

Mr. **Gibbons** [presiding]. Well, thank you all very much. I am going to take your testimony with me and read it. I appreciate it.

Our next panel is the National Cooperative Business Association, Mr. Len Yaeger. Also we have Mark S. Ellis, a partner with Irvin & Ellis, Washington, DC.

Chairman **Rostenkowski**. Gentlemen, welcome to the committee. You may proceed with your testimony.

STATEMENT OF LEN YAEGER, VICE PRESIDENT, INTERNATIONAL BUSINESS, AND CHIEF OPERATING OFFICER, COOPERATIVE BUSINESS INTERNATIONAL, NATIONAL COOPERATIVE BUSINESS ASSOCIATION

Mr. **Yaeger**. I am Len Yaeger, chief operating officer of Cooperative Business International. Cooperative Business International is a wholly-owned subsidiary of the National Cooperative Business Association and was established to promote trade and joint ventures among the world's cooperatives.

Honorable Chairman Rostenkowski and honorable members of the Ways and Means Committee, on behalf of the National Business Cooperative Association and our president, Bob Scherer, I am glad to have the opportunity to testify today. We have served cooperative businesses for over 70 years. Today we represent 60 million Americans, members of 40,000 cooperatives.

Since World War II, the National Cooperative Business Association has been directly involved in scores of countries under contract to AID and others in the development of cooperatives. We believe the United States should make use now of our cooperative system to develop free market economies and introduce democracy in Europe and the U.S.S.R. Presently there are 100 million members of cooperatives in the U.S.S.R. and other Eastern European countries.

Given their existing structure and economic potential it is critical that they return to their original free market foundations. Most were formed before their countries were taken over by the Communists. The first priority should be given to democratizing these cooperatives and placing them back in the hands of their members. Renewal of the Eastern European economies will be quicker, and more cost-effective through reconstruction of these existing cooperative sectors.

Many of these cooperatives have already taken the lead in export/import activities. That is why the National Cooperative Business Association fully supports passage of H.R. 2307 introduced by Congressman Pease, which provides special tariff treatment for products of qualified cooperative enterprises in certain nonmarket economies.

We also encourage this committee to consider a special trade package of approximately $2½ million over 3 years to permit the U.S. cooperative sector to provide technical assistance and market development services to develop trade linkages and joint ventures with the cooperatives of Eastern Europe. We believe this startup funding would help to establish a long-term dynamic relationship among our cooperative organizations and go a long way toward institutionalizing a democratic free enterprise approach to economic reform in Eastern Europe.

The NCBA and its members stand ready to work with Congress on this issue. As our association's testimony points out, there is a long and successful tradition of the U.S. Congress using cooperatives to revitalize and build economies during periods of crisis.

First, look at the role of co-ops created by Congress in winning the war against the 1930's Depression in rural America. Many of the ideas of that period, such as rural electric co-ops and credit unions, have now been successfully exported to many developing nations.

Second, the president of the NCBA was appointed to the U.S. Government delegation to the U.N. food conference in 1943. This looked at how cooperatives could play a role in the reconstruction of Europe. The conference reported that cooperatives were so widespread throughout Europe they represented a practical, efficient, and nonprofit method of distribution.

That is as true for Eastern Europe in 1990 as it was for Western Europe then. Western European cooperatives representing their 100 million members are already at work building trade and business bridges to their counterparts in the East. Italian co-ops are trading with the East Germans; the German agricultural co-op bank is in a joint venture bank in Budapest with the Hungarian agricultural cooperatives; and, the national consumer cooperative organizations of five Eastern European countries are now trading members of Inter-Coop.

Inter-Coop is a buying link for 3,000 consumer cooperatives in Western Europe with annual sales of over $30 billion. Because of NCBA's long ties to the International Cooperative Alliance based in Geneva, we have the opportunity to work closely and effectively with our Western European colleagues. This potential United States-European co-op partnership is key to developing strong trading partners in Eastern Europe.

Third, Congress has consistently funded cooperative development in the Third World to foster economic growth. The U.S. Government's success stories in developing cooperatives in the Third World have much application in Eastern Europe and the U.S.S.R. NCBA has received many requests for assistance from cooperatives in Eastern Europe during innumerable visits to Poland, Hungary, and Czechoslovakia. With our assistance, these cooperatives could be participating in the emerging free-market economy. In addition, the co-ops are a training ground for self-government. As President Wilson said, "The highest form of efficiency is the spontaneous cooperation of a free people."

As our written testimony will show, if we focus on rebuilding the cooperatives, we will have created a great opportunity.

Thank you, Mr. Chairman and honorable members.

Chairman Rostenkowski. Thank you.

[The statement of Robert D. Scherer as presented by Mr. Yaeger follows:]

National Cooperative Business Association

President, Robert D. Scherer
1401 New York Ave., N.W.
Washington, D.C. 20005

This testimony is prepared for the January 31st hearing of the House Ways and Means Committee on "U.S. Trade Relations with the Soviet Union and Eastern Europe." The testimony was prepared by Len Yeager, NCBA's Vice President of International Business and Chief Operating Officer of Cooperative Business International (CBI) and David J. Thompson, NCBA's Director of International Relations.

Let freedom ring! 1989 was full of walls tumbling down, dictators falling and the collapse of tired, outdated governments in Eastern Europe. Almost daily the people of America watched in awe as fifty years of barriers were swept away. Around the globe people witnessed almost overnight a brave new world emerge.

Then the clock struck 12. A new decade was born. The bright Christmas lights came down, and the euphoria dimmed as reality set in. Freedom had arrived on a cold winter morning and the cupboards in Eastern Europe were nearly empty.

After decades of political distortion, Eastern Europe is in ruins. Only the most massive infusion of assistance in every form will re-build the foundation of this key area of the globe.

Over 100 million members of cooperatives in Eastern Europe and the U.S.S.R have asked the U.S. cooperatives to help them return to a free market economy.

Over 100 million members of cooperatives in Western Europe have already begun to help their Eastern European counterparts.

60 million members of cooperatives in the U.S.A. would like to help the cooperatives of Eastern Europe. The U.S. cooperatives have tremendous human resources and organizational capabilities to offer. The U.S. can offer the experience of the most refined cooperative sector in the free market economy. The East Europeans' co-ops need and want a partnership with U.S. co-ops. Working together we have the tools to rebuild their cooperatives and help renew those economies.

The U.S. government has a history of supporting cooperative development to build strong democracies and strong business. We did it in America during the Depression; we did it in Western Europe and Japan after the war and we're doing it today throughout the developing world. It's a time tested method that has united people during the worst of times to create a foundation for the future.

This testimony strongly supports 2 important items:

1. passage of H.R. 2307 by Congressman Donald Pease, and
2. your consideration of a special cooperative trade package for Eastern Europe.

There are over 100 million members of cooperatives in Eastern Europe and the U.S.S.R. For nearly 150 years the cooperatives have helped their members. However, stymied by government and political interference from first the Nazis and then the Communists, the cooperatives are now returning to member control. With their billions of dollars of volume, and millions of staff, cooperatives are found in every village of Eastern Europe. Especially critical to the re-organization of agriculture and the rural economy, cooperatives are often the most important business of the community.

There are over 100 million members of cooperatives in Western Europe. For nearly 150 years they've been a leading sector of the economy of the region. Nearly 40% of all agricultural activity in the Common Market occurs through cooperatives; at least one out of every 3 banking offices in Western Europe is owned by a cooperative credit institution; and 3,000 consumer cooperatives in Western Europe have an annual turnover of 40 billion dollars through their nearly 30,000 sales outlets. Cooperatives are found in every sector of economic activity in Western Europe.

Sensing impending changes in Eastern Europe, the Western European cooperatives have been preparing for the openings.

For example, Inter-Coop was established to conduct joint buying for the 3,000 Western European consumer co-ops in 1971. Today, the consumer cooperatives of Bulgaria, Czechoslovakia, Hungary, Poland and Yugoslavia are all active members trading through Inter-Coop; Unico, one of the world's largest banking groups is owned by 6 cooperative banks in Western Europe and has over 30,000 branches. Through its subsidiary Unico Trading based in Vienna, it has become a leader in East-West trade; a consortium of Western European agricultural co-ops has opened an office in Hungary; the West German Agricultural Cooperative Bank has opened a joint venture bank with the Hungarian agricultural cooperatives in Budapest and will likely do the same in Czechoslovakia; the Swedish housing co-ops are working directly with the Polish housing co-ops; the Swedish consumer co-ops are already building a hotel in a joint venture in the Soviet Union; and the Italian consumer cooperatives last year signed a major trade deal with the Soviet consumer cooperatives.

There are over 60 million Americans served by over 40,000 cooperatives, many of them similar in activity to those in Eastern Europe. The key ones in the U.S. are credit unions, farm market and supply, agricultural credit, rural electric and rural telephone, housing, child care and small business cooperatives. Here in the U.S.A. cooperative enterprises are a healthy contributor to the U.S. economy with billions of dollars of economic activity and millions of people employed.

For the past 150 years cooperatives in the U.S.A. have grown, diversified and adapted to our continuously changing, dynamic economy. As a result, we have created the most diversified cooperative sector in the world. Even the mature, sophisticated European cooperators are in awe of our range of different cooperatives. Many of our ideas have successfully been transferred to developing countries.

INTERNATIONAL DEVELOPMENT OF COOPERATIVES

The NCBA has participated in international cooperative activities since its beginning in 1918. U.S. cooperators began to play a leading role in the International Cooperative Alliance (ICA) from the 1930's onward. As the sole U.S. member of the ICA, the NCBA has been an effective voice for U.S. cooperatives. Bob Scherer, NCBA President, is also the ICA representative to the United Nations.

After the Second World War the NCBA (then known as CLUSA) became the first home for a newly emerging organization named CARE (Cooperatives for American Remittances to Europe). Murray Lincoln, the first president of CARE, credits a member of the President's War Relief Control Board for initiating the idea. Wally Campbell, Secretary of NCBA's International Committee which had been raising funds to help co-ops and cooperators in Europe, took up the challenge and CARE was born as a non-profit cooperative in 1945.

With U.S. government responsiveness and the public's enthusiastic support, CARE has become one of the most recognized and loved names in the world. Murray Lincoln, a member of the United States delegation to the 1943 U.N. Food and Agricultural Conferences became one of the great U.S. co-op leaders to emerge in the post-war era.

From its experiences with fostering CARE, the NCBA began its direct role in development abroad. For the past 40 years the NCBA has been developing cooperatives in the developing world. One of the NCBA's greatest achievements is in India where the Association has had a permanent office for 30 years. Our long term investment in cooperatives and democracy has paid off. As of 1989, there were 120,000,000 members of Indian cooperatives, the second largest movement in the world.

The NCBA took great pride in seeing its nominee win the World Food Prize last year. Dr. V. Kurien, head of Operation Flood in India, is one of NCBA's partners in development. His dynamic leadership and use of the cooperative as a tool for development and democracy is one of the success stories of our time.

What we have seen in India and elsewhere in our work is the unforgettable role that cooperatives play in fostering democracy, enterprise, and leadership. The cooperatives at the local levels are training grounds for democracy. In nations like India, and

Japan in the 1950's, the local cooperatives created the daily democracy of business life in the community. Trained as leaders in the cooperatives, many people went on to become local and nationally elected public officials.

In the Eastern European nations political democracy is returning. However, democracy at birth is a fragile instrument. One way to strengthen political democracy is to create democracy at many other levels in society. The fostering of political parties, trade unions, and professional societies all are of value. However, cooperatives are unique; they are both a democracy and an economic enterprise. They must meet the needs of their members yet operate within a market economy. They must create efficiencies through scale yet serve the individual member.

In nations such as we are targeting, economic dislocation is inevitable and painful;. Things will get worse before they get better as the market economy replaces the planned economy. During this massive transition, cooperatives can help their members work together to create new structures for the cooperative and for the new economic society.

EASTERN EUROPE

For the past 5 years the NCBA has been cultivating relations with the Eastern European cooperatives. During this time the NCBA has participated in a series of exchanges between U.S. cooperatives and the U.S.S.R., Poland, Hungary and Czechoslovakia. These exchanges of leaders have led to extensive discussions of trade, and the potential for joint activities in cooperative insurance, cooperative banking and credit unions. Until last year, permission to start those types of enterprises was forbidden.

At each annual meeting of the International Cooperative Alliance over the past five years, our president Bob Scherer and our NCBA delegation leaders have met with the leaders of the Eastern European cooperatives. At our last meeting in India in October, 1989, each one of the movements asked us to help them. As a non-profit trade association with limited resources we can meet only a small portion of their requests. That is why we support the legislation introduced by Congressman Donald Pease, HR 2307.

We believe that extending special tariff treatment to qualified cooperatives in non-market economies has certain advantages. Because the cooperatives who obtain the special tariff treatment have already met certain standards, they as a firm are models of a democratic business operating without government interference. HR 2307 would create an incentive for non-market economies to open up their economies.

The purpose of the foundation created by this legislation is to increase and strengthen the trade and commercial linkages between the U.S. and the qualified cooperatives in non-market economies. The foundation's intended task is to focus on creating opportunities for East-West business.

The NCBA believes strongly that this legislation will create a focal point for opening up the non-market economies and increasing specific trade opportunities for the U.S. We urge your support.

We also strongly suggest your consideration of a cooperative trade package for Eastern Europe and the U.S.S.R. The shopping lists asked of us by our Eastern European counterparts is long: trade, counter-trade, machinery, packaging and processing equipment, technological transfer, joint-ventures, financial investment, professional exchanges, training, academic exchanges, organizational development, tax and legislative guidance, assistance in starting other forms of cooperative enterprises, etc. The following proposed plan can help meet the needs of the Eastern European cooperatives. An important point to repeat: the most successful U.S. initiatives in Eastern Europe will utilize strong active partners in Western Europe. The U.S. and Western European cooperatives can work together effectively on key issues such as the Common Market initiatives and the three-way trade that will be the cornerstone of much of the U.S. involvement.

Chairman Rostenkowski. Mr. Ellis.

STATEMENT OF MARK S. ELLIS, PARTNER, IRVIN & ELLIS, WASHINGTON, DC

Mr. Ellis. Thank you, Mr. Chairman. I will be basing my testimony on my recent experience in Yugoslavia for 2½ years on a Fulbright grant, assisting the Yugoslav Government in implementing its foreign investment laws.

The countries of Eastern Europe are now struggling with many of the same problems that Yugoslavia started to face in the mid-1980's when it decided to move toward a market-oriented economy. This undertaking was premised on the most revolutionary transformation of Yugoslavia's legal system since the introduction of its uniquely structured Socialist self-management system in 1950.

In doing so, Yugoslavia radically redefined the well established, albeit economically dubious, suppositions of Socialist principles such as ownership, property, and capital. The same conceptual transformation is now occurring in Eastern Europe.

Yugoslavia's experience provides examples of successful and unsuccessful attempts to institute a market economy. For instance, the first two postwar stock markets in Yugoslavia have been successfully established this past year. Additionally, its foreign exchange law of 1988 provides a valuable lesson in how to move to a convertible currency from an essentially administrative system of hard currency allocation.

The prevailing thought, however, must be to adhere to the more positive substantive changes that have taken place in Yugoslavia while avoiding the inherently inefficient principles of Yugoslavia's self-management system. This includes the amorphous concepts embodied in "social ownership." Chief among these is a decision-making procedure that is overly bureaucratic and tends to ignore the role of profit.

Discussions I had recently in Poland and East Germany revealed a concept of "economic democracy" in which employers and workers, would have equal rights and in which workers' councils, similar to that in Yugoslavia, would act as a basis for self-managing co-operation. This democratization, within the firm, however, is not a panacea for the successful reforms in Eastern Europe. One needs only to look at Yugoslavia, with probably the highest degree of worker self-management in the world and yet an economy that is quite stifled, to realize the inherent weaknesses of this type of system.

Without coupling the democratization of the firm with strong management and a competitive economy, any move towards the concept of self-management would be without merit. Most importantly, though, Yugoslavia shows the necessity of Socialist countries to be guided at the onset by legal experts who can assist in transforming the legal institutions within these countries. The necessary legal reforms are so fundamental and the ramifications so complex that it is difficult right now to write the laws necessary to attract the foreign investment and stimulate trade from the West. Even when the political will exists, instituting a legal structure for a market economy is too great a task where there is no experience with a market economy.

Yugoslavia, we have learned, had major impediments to a successful implementation of its foreign investment law because it simply lacked the experience and knowledge with the principles that one must embody for these types of trade laws. Consequently, Yugoslavia squandered 2½ years in attempting to implement a foreign investment law which never took into consideration the standard international legal concepts that one needs in order to attract foreign investment.

In order to assure that substantive areas of the law are adopted in Eastern Europe, there needs to be an institutionalized project focused at facilitating and assisting in the development of legal reforms in Eastern Europe.

One of the most intriguing ideas has been proposed by the American Bar Association under the leadership of President Elect Talbot "Sandy" D'Alemberte. Under the international law and practice section, the ABA is exploring a program called the East European Law Institute. The premise of this project mirrors my discussion which is that the existence of a proper legal infrastructure is a prerequisite to economic integration into a global economy.

As Yugoslavia shows, the presence of such a legal structure is basic to implementing these concepts within the market economy. One cannot develop a market economy without establishing the legal infrastructure. Thus, the institute would be located in the United States and would serve as an institutional focus acting as a coordinating point and a source of information for counterpart institutions which would be established in each participating East European country.

Together these established institutes would work toward establishing correct model commercial laws and would assist in reviewing, assessing and supplementing the numerous commercial laws that must be in place before a market-oriented economy can be successfully implemented.

Thus, in providing the institutional support, the United States will be assured of a long-term involvement with the reform process and will certainly provide a catalyst for the successful implementation of legal reform throughout Eastern Europe.

[The statement of Mr. Ellis follows:]

Hearing before the Honorable Dan Rostenkowski,
Chairman, Committee on Ways and Means

January 31, 1990

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SUMMARY

The countries of Eastern Europe are struggling with many of the same problems that Yugoslavia started to face in the mid 1980's when it decided to move towards a market-oriented economy. This undertaking was premised on the most revolutionary transformation of Yugoslavia's legal system since the introduction of its uniquely structured socialist self-management system in 1950. In doing so, Yugoslavia radically redefined the well established, albeit economically dubious, suppositions of socialist principles such as ownership property and capital. The same conceptual transformation is now occurring in Eastern Europe.

Yugoslavia's experience provides examples of successful and unsuccessful attempts to institute a market economy. For instance, the first two post war stock markets in Yugoslavia have been successfully established this past year. Its Foreign Exchange Law of 1988 provides a valuable lesson in how to move to a convertible currency from an essentially administrative system of hard currency allocation.

On the negative side, Yugoslavia's experiment with "economic democracy" through workers' self-management has proven that such similar developments in Eastern Europe will not be the panacea for successful reform of socialist economies. Discussions I have had in Poland and East Germany revealed a propensity towards "economic democracy" in which employers, workers and entrepreneurs would have equal rights and in which workers' councils, along with trade associations, would serve as the basis for self-managing co-operation. Yet such an approach will have little economic viability if it is not coupled with strong management that can reinvest profits and does so in a competitive economy.

The experience in Yugoslavia also shows the necessity for socialist countries to be guided at the outset by legal experts in market economies. The legal institutes required in socialist economies are so fundamental and the ramifications so complex that it is often not possible for lawyers and economists in these countries to write laws that will attract foreign capital and stimulate trade from the West. Even when the political will exists, instituting a legal infrastructure for a market economy is too great a task where there is no experience with a market economy.

We have learned through our experience in Yugoslavia that one of the major impediments to the successful implementation of legal reforms has been the lack of knowledge about and experience with the concepts embodied in a legal system premised on a market-oriented economy. In many areas, Yugoslavia has attempted to adopt legal reforms without sufficient adherence to international standards. For instance, Yugoslavia spent nearly two years modifying its Joint Venture Law, each time falling short of accepting legal provisions needed to attract substantial foreign investment. The same syndrome is duplicating itself throughout Eastern Europe.

To assure that the numerous substantive areas of legal reform are adopted expeditiously and in full accordance with accepted international standards and practices, there must emerge an institutionalized project focused on facilitating and assisting the development of legal reform in Eastern Europe. One very intriguing initiative has been developed by the American Bar Association. The ABA, through its Section on International Law and Practice, is exploring a project entitled the "East European Law Institute." The premise of this project mirrors my discussion today; that is, the existence of a proper commercial legal infrastructure is a prerequisite to economic integration into the global economy.

The ABA's proposed "East European Law Institute" would be located in the United States and would serve as an institutional focus, coordinating point and source of information for counterpart institutes established in each participating East European country. The Institute would make available U.S. legal experts in the development of model commercial laws. Legal reform priorities would be established by the counterpart institutes. The Institute would assist in reviewing, assessing, supplementing and implementing new commercial laws.

In providing the institutional support, the United States will be assured a long-term involvement with the reform process and will provide a catalyst for the successful implementation of legal reform in Eastern Europe.

LEGAL REFORM IN EASTERN EUROPE - LESSONS LEARNED FROM YUGOSLAVIA

Mark S. Ellis *

By 1987, Yugoslavia had embarked on an historic endeavor intended to transform its entire economy by incorporating the most fundamental elements of a market-oriented economy. This undertaking was premised on the most revolutionary transformation of Yugoslavia's legal basis since the introduction of its uniquely structured socialist self-management system in 1950. The legal restructuring precipitated the introduction of substantial constitutional revisions and significant modifications to a number of laws which functioned as the basis of Yugoslavia's socialist self-management system. Among these laws were: the Joint Venture Law; the Law on Enterprises; the Law on Long-Term Cooperation; the Law on Labor; the Law on Financial Operations; the Foreign Exchange Law; the Law on Banking; the Law on Import and Export of Goods and Services; the Customs Law; the Law on Accounting; the Law on Bankruptcy and the Law on the Basics of the Tax System.

The reshaping of any one of these laws is significant enough to warrant notice, for each of these laws embodied principals which were fundamental to a socialist economy. Yet because past attempts at piecemeal adjustments had failed, Yugoslavia is attempting to create a reformation across the board. Rather than an incremental and separate modification of each of these laws, Yugoslavia introduced a conceptual transformation of its entire legal system, based on market principles. In doing so, Yugoslavia radically redefined the well established, albeit economically dubious, suppositions of socialist principles such as ownership, property and capital. This same conceptual transformation is now occurring in Eastern Europe.

Yugoslavia's legal restructuring, which got under way in earnest in 1987, remains in transition today. Yugoslavia's experience provides an important guide to the current restructuring process in Eastern Europe. Lessons to be learned from Yugoslavia's efforts are both of substantive and procedural nature.

In the area of substantive reforms, Yugoslavia's newly enacted laws will undoubtedly act as a benchmark for similarly enacted laws throughout Eastern Europe. For instance, the first two post war stock markets in Yugoslavia were established in Ljubljana and Belgrade this past year. The Foreign Exchange Law of 1988 provided a valuable lesson in how to move to a convertible currency from an essentially administrative system for hard currency allocation. Now Yugoslavia's new foreign exchange policy, with a convertible currency, has resulted in a healthy current account surplus. Its

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* Mr. Ellis practices law in Washington, D.C. He has recently returned from a two and one-half years stay as a **Fulbright Scholar** at the Economic Institute in Zagreb, Yugoslavia. He is also the past recipient of two research grants to Brussels, Belgium and a summer postgraduate grant to Yugoslavia.

Mr. Ellis is the coauthor and coeditor of the book, **DOING BUSINESS WITH YUGOSLAVIA - ECONOMIC AND LEGAL ASPECTS**. He has also published numerous articles on investing in foreign countries and trade with the European Economic Community.

Mr. Ellis has presented a score of papers on foreign investment, including lectures to the **World Bank**, the **International Finance Corporation** (IFC), the **U.S. - Yugoslav Economic Council**, the **Overseas Private Investment Corporation** (OPIC), the **Boeing Corporation** and the **Yugoslav Government**. In addition, he is a consultant to private firms and to both the **World Bank** and the **International Finance Corporation**. Mr. Ellis has also represented the United States on lecture series in Yugoslavia, Poland and East Germany, sponsored by the **United States Information Service** (USIS). (Telephone Number 202-638-0201.)

newly proposed Bankruptcy Law allows creditors and debtors, rather than the Government, to initiate bankruptcy procedures.

The prevailing thought in Eastern Europe should be to adhere to the positive substantive changes occurring in Yugoslavia while avoiding the inherently ineffective principles of Yugoslavia's self-management system including those connected with the amorphous concept of "social" ownership of enterprises. Chief among these is a decision-making process which is overly bureaucratic and tends towards immediate amelioration of workers' condition, rather than long term investment of profit. In Yugoslavia, this system is exasperated by several factors which tend to protect enterprises from the economic consequence of their management policy, including regional monopolies in many industries.

Discussions I had in Poland and East Germany last month revealed a propensity towards "economic democracy" in which employers, workers and entrepreneurs would have equal rights and in which workers' councils, along with trade associations, would serve as the basis for self-managing cooperation. Such developments at the level of the firm, however, are not the panacea for successful reform of socialist economies. One needs only to view Yugoslavia, with the highest degree of workers' self-management among socialist countries and a stifled economy, to realize that "economic democracy" has very little economic viability if it is not coupled with a strong management that can invest profits and does so in a competitive economy.

To assure that the numerous substantive areas of legal reforms are adopted expeditiously and in full accordance with accepted international standards and practices, there must emerge an institutionalized project focused on facilitating and assisting the development of legal reform in Eastern Europe. We have learned through our experience in Yugoslavia, that one of the major impediments to the successful implementation of legal reforms has been due simply to the lack of knowledge about and experience with the concepts embodied in a legal system premised on a market-oriented economy. In many areas, Yugoslavia has attempted to adopt legal reforms without sufficient adherence to international standards. For instance, Yugoslavia spent nearly two years modifying its joint venture law, each time falling short of accepting legal provisions needed to attract substantial foreign investment. This same syndrome is duplicating itself throughout Eastern Europe.

For instance, Poland and Czechoslovakia have recently adopted foreign investment laws which are inadequate when compared to international principles and which seem to be unmindful of the Yugoslav experience.

Poland's Foreign Investment Law places limitations on those joint ventures which do not maintain sufficient exports; it permits the Ministry of Finance to stipulate the general principles of accounting rather than adhering to international standards; it requires a set percentage of the joint venture's foreign currency export proceeds to be sold to a Polish bank; it maintains an excessive corporate income tax; and the Law does not permit foreign businesses to exchange their zloty revenue for foreign exchange, thus requiring firms to export their products if they desire to recoup foreign exchange revenue.

For Czechoslovakia, similar restrictions exist including a prohibition against repatriating profit in hard-currency; inability to obtain foreign exchange for the purpose of purchasing imports for the joint venture unless the joint venture earns foreign exchange on exports; and limitations on payment of technology license fees and royalties.

One of the objectives of these hearings is to assess the prospects for improved economic and trade relations with the East

European countries. A paramount goal in U.S. policy towards Eastern Europe should be to facilitate the means to assist these countries in instituting legal reforms. At the very least, such an initiative would assure long-term involvement with the massive legal restructuring efforts needed in Eastern Europe and would balance similar initiatives being proffered by members of the European Community.

One very intriguing initiative has been developed by the American Bar Association. The ABA, through its Section on International Law and Practice, is exploring a project entitled the "East European Law Institute." The premise of this project mirrors my discussion today; that is, the existence of a proper commercial legal infrastructure is a prerequisite to economic integration into the global economy. International trade, direct foreign investment, joint ventures, and other forms of international commercial transactions depend on an established market-oriented legal framework, providing rules of the game, predictability and legal protections. As the Yugoslav experience shows, the presence of such a legal structure is basic to and must proceed growth in a market economy. In other words, you cannot develop a market economy without first establishing the legal infrastructure which a market economy requires.

The ABA's proposed "East European Law Institute" would be located in the United States and would serve as an institutional focus, coordinating point and source of information, for counterpart institutes established in each participating East European country. The Institute would make available U.S. legal experts in the development of model commercial laws. Legal reform priorities would be established by the counterpart institutes in each participating East European country. The Institute would assist in reviewing, assessing, supplementing, and implementing new commercial laws. A process parallel to the development of model laws, this program would be available in countries, such as Poland, in which a large number of new laws have already been adopted.

In addition to Yugoslavia, both the PRC and the USSR have adopted numerous commercial legal reforms designed to induce a greater level of trade and investment. Case studies of the adoption and subsequent modification of, for example, joint venture laws could demonstrate what responses, on the part of potential U.S. joint ventures and other investors, greeted different legal innovations and provisions.

An ABA-sponsored East European Law Institute would incorporate a variety of components drawn from models ranging from prior ABA projects involving the Soviet Union and the PRC to the highly successful Caribbean Law Institute. The Institute would stress educational elements such as legal seminars, both in the United States and Eastern Europe.

Extended legal programs would be initiated in the same way that the Benjamin Cardozo Law School has scheduled a seven week curriculum for business law in Budapest. Comparable programs could be organized in the United States for East European Lawyers.

The ABA's CLE-TV program would also be incorporated into the educational format of the Institute. This program, which produces highly professional videos on legal subjects, offers the flexibility of formats, modest expense, ease of distribution, and great versatility. Drawing upon USIA assets and experience, even satellite transmissions are possible.

For all of the educational programs, the ABA would draw on the resources of its 365,000 members.

The countries in Eastern Europe are struggling with many of the same problems that Yugoslavia started to face in the 1980's when it decided to move towards a market-oriented economy. Yugoslavia's experience provides examples of both successful and unsuccessful attempts to institute a market economy and shows the necessity for socialist countries to be guided at the outset by legal experts in market economies. The legal institutions required in socialist economies are so fundamental and the ramifications so complex that it is often not possible for lawyers and economists in these countries to introduce laws that will attract foreign capital and stimulate trade with the West. Even where the political will exists, instituting a legal infrastructure for a market economy is too great a task where there is no experience with a market economy. In providing the institutional support, the United States will be assured a long-term involvement with the reform process and will provide a needed catalyst for the successful implementation of legal reform in Eastern Europe.

Chairman ROSTENKOWSKI. Thank you.

Mr. Gibbons.

Mr. GIBBONS. Mr. Ellis, you were so right. I appreciate your coming and saying that. In one of my trips over in that area, I became aware of the fact that they have nothing on entrepreneurships, partnerships, real corporations; they have no cost accounting rules or anything like that.

It is really germane to what you have to do to have a market economy. I hope that there is some way that the private sector in America—perhaps the American Bar Association is the right group and I will certainly talk to Sandy Dowlingburg about it—can get some hands-on help for them. They have the books, they have the libraries but they have never had any practical experience.

Talk about free elections. They don't have any election laws that work for free elections. They don't know how to elect the people, from geographic districts, lists or whatever. What they select in all of that is going to be very, very important as to the kind of systems they will finally end up with.

In addition to that, they have one real big problem: the only real political party in existence is that lousy Communist Party. They are the only people prepared to run an election. They have a bunch of splinter groups and they might end up with a system that is still dominated by the Communists because they just don't know how to run an election, don't know how to campaign. They just don't know the fundamentals of a free society. We really need to help them there. It is just like walking out of the Stone Age into the modern age and saying, oh yes, heard about this, read books on it, people told me how to do it but I have no feel for it.

It is like trying to assemble a tinker toy with your eyes blindfolded. It is a tough job. I applaud what you are doing. I would like to talk to you sometime further about your businesses in Yugoslavia.

Thank you.

Chairman ROSTENKOWSKI. Mr. Pease.

Mr. PEASE. Thank you Mr. Chairman.

I would like to thank both of our witnesses and in particular Mr. Yaeger because I have had a longstanding interest in cooperatives, and I really believe that cooperatives can fulfill a major part of our effort to help Eastern European countries adjust to the freedom of our system.

Two weeks ago today, I was in Prague, and I met with the president and executive director of the National Association of Farmer Cooperatives in Czechoslovakia. They are extremely eager to get help from the United States particularly technical help, managerial help.

In the last couple of hours I have been on the phone with those people from Czechoslovakia to try to encourage that. You made reference, Mr. Yaeger, to my bill. My bill was drafted about 1 year ago, when it looked as if there were going to be some openings, particularly in the Soviet Union. Of course, none of the dramatic events in Eastern Europe had taken hold as of that point. The idea of my legislation was to say that rather than to repeal Jackson-Vanik or waive Jackson-Vanik in its entirely, we ought to go in a step-by-step process and first try to do a partial waiver of Jackson-Vanik, conferring MFN treatment on that part of the Soviet economy which is most encouraging from the viewpoint of both free enterprise and democracy.

That sector of the Soviet economy is the cooperative movement. This holds true also for Eastern Europe. Since then, particularly in the countries of Eastern Europe, those nations have been running pell mell toward full democracy and full free enterprise.

Making the kinds of distinctions between cooperative enterprises and others may not be as valid now as it was at that point. In a sense, my bill has been overtaken by the dramatic events in Eastern Europe. But I do think that as we try to encourage further progress toward free enterprise and democracy in Eastern Europe, that we in the United States would be foolish not to take full advantage of the American cooperative movement. I was heartened by your testimony and by the steps that your American group has already taken to establish links and relationships with cooperatives in Eastern Europe.

I wonder if you might repeat for the members of the committee and for the record what specific events you think might be taken here in the United States which would be of technical value in terms of encouraging the cooperative movement in Eastern Europe.

Mr. YAEGER. Thank you, Congressman Pease.

I mentioned in my presentation the possibility of the cooperative movement in the United States receiving a $2.5 million package to promote trade and other linkages with the Eastern European coops.

I did that not out of thin air but Cooperative Business International and the National Cooperative Business Association received a $1.9 million grant from AID in 1984 to start up Cooperative Business International. AID's idea was to try and promote exports from less developed country cooperatives. We, for many months, tried to be all things to all people and float around the world and try to make this thing work.

We finally realized that the only way we could do that was by taking advantage of having people in the country so we could do the exhaustive work of developing products and establishing marketing linkages. AID has always been very good in the production and technical assistance area but maybe a little weak in the marketing and linkage area.

That is the vacuum we tried to fill. We built on 30 years of development assistance financed by AID in countries like India, Indonesia, and Bangladesh. With the help of the AID grant, we were able to put people into those countries and developed to a point where annual trade with these three countries approximates $40 million a year now.

We were evaluated by AID in April 1989. It was a very positive evaluation. I think I see very little difference in trying to move ahead with some of the countries in Eastern Europe than the experiences we had in those three Asian countries.

We need startup funding. We need some risk capital to be able to finance the visits, the exchanges of technical people and do the very costly work of product development and marketing promotion.

I might add that none of the products that we import from these three Asian countries competes with U.S.-produced products.

Mr. **Pease**. Thank you very much. I think your association does excellent work. As I mentioned before, I also believe that there is huge potential for the United States to help the countries of Eastern Europe in a very practical, down-to-earth, productive way, using the American cooperative movement as a vehicle for those changes.

So I would like to encourage you and pledge any support that I can give you and your colleagues as you go about doing that. I certainly will be happy to contact and even testify before the House Foreign Affairs Committee in support of some money from AID for the purposes you have just outlined.

Thank you.

Chairman **Rostenkowski**. Mr. Cardin.

Mr. **Cardin**. I have no questions, Mr. Chairman.

Chairman **Rostenkowski**. Thank you gentlemen. Thank you for joining us.

Our colleague, Mr. Frank Wolf of Virginia. Welcome to the committee Frank. It is always a pleasure for us to have you give us the benefit of your observations.

STATEMENT OF HON. FRANK R. WOLF, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF VIRGINIA

Mr. **Wolf**. Thank you, Mr. Chairman.

I want to thank you for allowing me to testify on such short notice. I appreciate it very much. I traveled to Romania earlier this month to assess the Romanian people's opportunity to advance toward democracy. My recommendations stem from meetings with leaders on all sides, including opposition political parties, students and people in the streets, as well as officials of the interim government.

They asked us to help by channeling aid designed to prepare their society to hold free and fair elections. It is therefore imperative for the United States to help provide the "tools of democracy"—such as communications equipment, election apparatus, and training. It will be equally essential to encourage visits by U.S. officials, and by the U.S. Chamber of Commerce and other trade and business associations, to stimulate free enterprise and the promotion of United States-Romanian business and commercial ventures.

United States policy should seek to encourage movement toward democracy in Romania—the goal for which Romanians fought and died in the streets, and the end which is most consistent with our national interest.

It is for this reason, which I believe reflects both Romanian aspirations and U.S. interests, that I support granting most-favored-nation status to Romania only after the completion of free, fair, open, and verifiable elections in Romania.

The Romanian people are hopeful, but increasingly skeptical, that the present authorities will follow through on their public pronouncements about establishing freedom, pluralism, and the protection of basic human rights in Romania.

And I would share with you the common plea of many Romanians both within and outside the National Salvation Front—do not "repeat Yalta" by legitimizing Romanian authorities not freely chosen by the people. Demonstrations last week in the streets of Bucharest have punctuated their growing fear that Romania's revolution for democracy may be in peril. Three different prominent Romanian leaders last week announced separately their resignations from the National Salvation Front: the Front's Vice Chairman Dumitru Mazilu; Romania's most respected dissident Doina Cornea; and the Hungarian Reformed pastor whose plight sparked the revolution, Laszlo Tokes.

The decision to support or vote out the present government belongs to the Romanian people who have truly earned it. It is not ours to undermine their opportunity for political expression against the clear wishes of those who fought hardest and suffered most to end the dictatorial regime of Nicholae Ceausescu.

I believe the United States was rightly among the first governments after the revolution that ousted Ceausescu to recognize the National Salvation Front Government. We rightly expressed optimism about its 10-point plan for human rights, free elections, and a market-oriented economy.

The 11-man ruling council of the Front welcomes the return of MFN, however, not simply for economic reasons. They covet the extension of support and legitimacy which MFN represents and practically provides. The once-thought "independent" and "liberal" Nicolae Ceausescu also wanted MFN.

I believe that Romania should be granted MFN. I want to see them get MFN and rebuild their economy and provide new opportunities for U.S. business investment. But only after the completion of free, fair, open, and verifiable elections in Romania.

The hopes of the Romanian people and United States-Romanian relations rest on significant progress and institutionalization of human rights, religious freedom, and the rights of Hungarians and other ethnic minorities. We must expect a track record of performance which has not yet happened.

In today's paper, Mary Battiata from the Washington Post, said from Bucharest,

> In the capital today, many citizens expressed concern over what they said was the Front's intimidation of independent political parties. Those interviewed on the street were afraid to criticize the Front and for the first time since the revolution many declined to give their names. Students in the underground said that pedestrians on the street at night were being stopped in the name of the Front by small bands of men who demanded education papers and asked if the pedestrians supported the Front.

When I was there, people would give you name, rank, and serial number and invite you to their house for dinner. I hope that is not changing. I hope that no matter what any officials request, we do not grant this government—referring to Romania and not necessarily other East European governments—but this government MFN status until there are elections held.

Chairman **Rostenkowski**. Thank you.

Are there any questions? The committee stands adjourned until 10 o'clock tomorrow morning.

[Whereupon, at 12:07 p.m., the committee was adjourned.]

U.S. RELATIONSHIPS WITH THE SOVIET UNION AND EASTERN EUROPE, THE IMPLICATIONS OF "EUROPE 1992" ON AMERICAN DIRECT INVESTMENT, AND FOREIGN INVESTMENT IN THE UNITED STATES

WEDNESDAY, FEBRUARY 28, 1990

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met, pursuant to notice, at 2:37 p.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. Good afternoon.

Today's hearing marks the continuation of hearings on the issue of United States trade with the Soviet Union and Eastern Europe, the implications of "Europe 1992" on United States direct investment and foreign investment in the United States. We have received testimony from a large number of private sector representatives on these issues.

The administration is now prepared to share its views with us. This afternoon, we will hear from the U.S. Trade Representative Carla Hills. Ambassador Hills is in a good position to inform members of this committee on the progress being made in negotiations with the Soviet Union and various Eastern European countries on trade and economic agreements.

She also will be able to address the question of how Europe 1992 is likely to affect the export and investment decisions of American businesses.

The issue of United States trade with former East bloc countries and EC 1992 are not separate and distinct issues. Recent press reports indicate that the EC is taking steps to create a continentwide free trade zone, possibly including the Soviet Union.

The committee will be interested in the Ambassador's view on how United States trade and investment interests may be affected by closer formal links between the European Community and East European countries. Finally, we are interested in Ambassador Hill's perspective on foreign investment in the United States.

These hearings will continue tomorrow with Secretary of Commerce Mosbacher. Secretary of State Baker and Secretary of the Treasury Brady are scheduled to appear on April 19.

Ambassador Hills, you are our leadoff administration witness, and I must say that I think you should be the cleanup hitter, because, in my opinion, you are going to be center stage of what is going to be happening with respect to our relationships with our newly found trading partners in Eastern Europe. I am hoping that you will act, as you always have in the past, with a firm hand, representing our country in a manner in which I think we are all proud.

Ambassador Hills, I welcome you, as I am sure the committee does as well, and look forward to your testimony. Before you proceed, I will yield to my colleague, Mr. Archer.

Mr. ARCHER. Thank you, Mr. Chairman.

Mr. Chairman, I join with you in welcoming Ambassador Hills before our committee.

You have had an outstanding record in the short period of time that you have been Special Trade Representative. We are very, very interested in hearing your views and comments on what you perceive as the great opportunities represented by Europe 1992, which is really Europe 1993—I do not know why we keep saying 1992. It is not supposed to start until January 1993—and how the events in Eastern Europe might impact on that.

Certainly, there are risks involved for us and there are challenges and there are great hopes and we welcome your input.

Ambassador HILLS. Thank you.

Chairman ROSTENKOWSKI. I will yield now to the gentleman with whom you will probably be working more closely, Mr. Sam Gibbons.

Mr. GIBBONS. Madam Ambassador, you have done a heck of a good job. Just keep up the good work, and if we can help, let me know.

Ambassador HILLS. Thank you very much.

Chairman ROSTENKOWSKI. Mr. Crane.

Mr. CRANE. Thank you, Mr. Chairman.

I, too, would like to extend a warm welcome to you, Ambassador Hills, as well as to our other guests who have attended today to hear your testimony.

Following several days of hearings with private sector witnesses, when they presented their views, we now are prepared to hear testimony from the administration on the key topics that have been raised, and that is EC 1992, East-West trade and foreign investment in the United States.

You are on the front lines of policy development with respect to these issues, primarily because of their important relationship to the Uruguay round of multilateral trade negotiations.

The economic integration of the European Communities and the effect of trade-related investment measures are posing new challenges for the multilateral trading system, as well as to bilateral trade with the United States. With the Uruguay round entering its critical final phase, we are greatly interested in your assessment of how investment practices in the 1992 single-market exercise are affecting progress in these crucial trade talks.

Also, changes are taking place in Eastern Europe and the Soviet Union so rapidly, the daily newspapers are having a hard time keeping up with the developments. Policymakers should respond much more slowly and deliberately.

When these hearings began in January, German unification was a possibility for the future, rather than the impending reality it is today. Now we are focused on a trade agreement with the Soviet Union that will lead to most-favored-nation trading status for that country perhaps as early as June.

The rapidity of the change in United States policy toward the Soviet Union concerns me deeply. Caution is the most prudent policy, in my view. I look forward to hearing your assessment of the status of trade talks with the Soviets and any problems you foresee in bringing a large economically backward nonmarket economy into the multilateral trading system.

Again, Madam Ambassador, I welcome you and look forward to hearing your testimony.

Chairman ROSTENKOWSKI. Ambassador Hills.

STATEMENT OF AMBASSADOR CARLA A. HILLS, U.S. TRADE REPRESENTATIVE

Ambassador HILLS. Thank you very much, Mr. Chairman, Chairman Gibbons, Mr. Archer and other members.

I am very pleased to be here today. I have sent up a written statement that is lengthy. With your permission, I would just make a few points that would summarize the written testimony, so that we would——

Chairman ROSTENKOWSKI. Without objection, Madam Ambassador, your entire statement will be included in the record and you may summarize, if you care to.

Ambassador HILLS. Thank you very much.

Let me say that political and economic reforms in Eastern Europe is transforming one of the most stagnant areas of the world. Working together with Congress, the administration responded by launching a wide-ranging assistance program for Poland and Hungary. The administration is proposing to expand this program of assistance to all the emerging members that are democracies in Eastern Europe and Yugoslavia.

As our trade and investment policy toward Eastern Europe complements our financial aid and our technical assistance, we seek to normalize trade relations and investment relations, and we will be looking for market-oriented reform, consisting of privatization, decentralization of economic decisionmaking, reliance on price mechanisms, adequate access for U.S. traders and investors to those countries' markets, and protection in those markets for U.S. investment and intellectual property.

Trade and investment agreements will provide reciprocal assurances and protections. The particular form of the agreements sought depends on whether the country in question already have most-favored-nation status and whether it is covered by the Jackson-Vanik amendment.

Subsequent to the President's announcement of a 1-year waiver of the Jackson-Vanik amendment during President Havel's recent visit here in Washington, we agreed to initiate the process of title VI trade agreement negotiations with Czechoslovakia and we will be meeting this week to have those discussions. We will also negotiate investment agreements with the Eastern European countries, including Yugoslavia.

In the case of Poland, which already has the benefit of most-favored-nations treatment, we are in the process of negotiating a business and economic agreement. A third round of negotiations on this agreement is scheduled for March 8, 9, and 10.

We have explored informally with the Hungarian Government negotiations on a similar agreement. After their elections in March, we will be meeting to hold those negotiations.

However, complete normalization of our trade relations with these Eastern European countries, especially GATT members such as Hungary, Czechoslovakia, and Romania, cannot occur as long as United States trade law—and I am referring to the Jackson-Vanik amendment here—conditions the grant of most-favored-nation status on the satisfaction of certain requirements. Furthermore, the full integration of these economies into the world trading system requires them to adopt a price-based economy.

Let me turn briefly to the Soviet Union, where we also are negotiating trade and investment agreements. Initial trade agreement talks were held in Washington on February 12 and 13. Title VI of the 1974 Trade Act requires, as a condition to granting the most-favored-nation status, a safeguards provision dealing with a threat of market disruption, intellectual property protection, and trade promotion. We envision that an investment agreement, as well.

As you know, President Bush and Chairman Gorbachev plan to sign a trade agreement at their meeting in June. The second round of negotiations leading up to that trade agreement are being held tomorrow and on Friday, and bilateral investment talks will follow on March 12 and 13.

Throughout all of these discussions, we are staying in close touch with the private sector and with members of Congress.

Now, turning my attention to EC 1992, there is no question, the exciting changes in Eastern Europe and the Soviet Union can distract us from looking at some very exciting changes going on in Western Europe. The outlines of the single market have clearly taken shape. On the whole, it is living up to its promise. Generally, it is being implemented in a trade expansionary manner.

During 1989, the Community drafted directives in the areas of banking, mergers, and transportation, which eased the fears of many that EC 1992 would result in new external barriers to trade.

The television broadcast directive, with its quota provision limiting access for foreign programs, was one exception, and the Commission's continued usage of antidumping circumvention cases implementing the rule of origin in a restrictive way has also been an area of difficulty for us.

I have discussed the rule of origin on several occasions with Commissioner Andriessen and Commissioner Scrivener, and they have assured me that their intention is to find a solution that is one of neutral application, and we will certainly continue our discussions with Commissioner Scrivener during her visit to Washington next week.

Another area in which EC policies may affect U.S. firms' decision with regard to locating in the Community is the automotive sector. The Commission is having a difficult time achieving a consensus among its 12 member states, and we have made our position quite clear.

EC measures should not inhibit sales in Europe, of American-built, Japanese name-plate autos, nor should they act as an artificial inducement for United States auto parts producers to establish facilities in Europe.

Other issues of importance to us with respect to the single-market program include public procurement. We want that market to be open. In telecommunications, I think we have made considerable progress. With respect to standards testing and certification, we want our private groups, such as Underwriters Laboratories, to be given a credence in the European market, and we would like to establish a bridge so that we can have common testing and certification. Biology technology is an area where European restrictions cause us concern.

We are talking about each of these issues with our counterparts, the Commissioners on the European Commission on a regular basis, because we want to be sure that when the trade barriers are removed within Europe, new barriers are not erected between Europe and the rest of the world.

Turning to foreign investment in the United States, there is no question: the rise in foreign ownership of U.S. assets has led to concerns about U.S. policy toward foreign investment. Since 1980, gross private domestic investment has been at 15.6 percent of our gross national product, near its historic norm. Gross savings declined sharply, however, to an average of only 13.8 percent of GNP, nearly 2.5 points less than its earlier historic average.

This savings and investment gap has required us to import foreign capital to finance our investment, and it is impossible to eliminate the U.S. trade deficit, without closing the gap between our domestic savings and our domestic investment. It is far preferable that the gap be closed through higher savings, rather than reduced investment.

Measures to reduce or restrict or discourage foreign investment would create problems for us, however, and it would send a foreboding signal to our trading partners that the United States will treat foreign investors differently than we treat domestic investors.

The principle of national treatment is enshrined in scores of our treaties, the friendship, commerce, and navigation treaties, bilateral investment treaties between the United States and its trading partners. We have also made commitments with respect to national treatment through a number of codes at the Organization of Economic Cooperation and Development, the OECD.

Restrictions on investment most likely would lead to reciprocal measures in foreign countries that could be used against our investors abroad. Such measures would seriously hamper our efforts to open markets for U.S. investors. The Omnibus Trade and Competitiveness Act includes the Exon-Florio provisions that provide clear authority for the President to bar purchases by foreigners on national security grounds.

Freer trade and investment raise real output, real incomes and our living standards, and the economic growth rate of this country and, thus, we are in favor of keeping the barriers with respect to investment down.

I am pleased to answer any of your questions.

[The statement of Ambassador Hills follows:]

TESTIMONY OF

AMBASSADOR CARLA A. HILLS

UNITED STATE TRADE REPRESENTATIVE

Good afternoon. It is a pleasure for me to appear before the Committee this afternoon. I look forward to discussing with you recent developments with regard to trade with the Soviet Union and the countries of Eastern Europe, the European Community's single market program, and foreign direct investment in the United States. In all three areas, the Bush Administration is pursuing a consistent policy of fostering freer play for market forces as the proven recipe for increasing economic opportunities and efficiency in the United States and internationally.

EASTERN AND CENTRAL EUROPE

Political and economic reform in Eastern Europe is transforming one of the most stagnant areas of the world into one of mind-boggling possibilities. Working together with the Congress, the Administration responded to the first reform initiatives by launching a wide-ranging assistance program for Poland and Hungary, which we have implemented pursuant to the "Support for East European Democracy" (SEED) Act of 1989 and through our cooperation with the Group of Twenty-Four (G-24) countries. This year the Administration has continued to promote the reform efforts by proposing legislation which will authorize assistance to all emerging democracies in Eastern Europe, and Yugoslavia, pursuing market-oriented reforms.

Our trade and investment policy toward Eastern Europe complements our financial aid and technical assistance. The trade and investment aspects of our policy are being coordinated by the interagency Trade Policy Review Group (TPRG), within the context of our broader foreign policy objectives. Very simply, we seek a normalization of relations with Eastern European countries to the extent that they are taking steps toward political pluralism (based on progress toward free and fair elections and an end to the monopoly of the communist party), respect for human rights, a willingness to build a friendly relationship with the United States, and movement toward market-oriented economies.

As we seek to normalize trade and investment relations with Eastern European countries we will be looking for:

1) market-oriented reform consisting of privatization, decentralization of economic decision-making and reliance on price mechanisms; and

2) adequate access for U.S. traders and investors to those countries' markets and protection in those markets for U.S. investments and intellectual property.

The degree and the speed of economic reform in these centrally-planned economies will be the determining factor in whether their economies develop and their products are able to become competitive in world markets. Hopefully the new leadership in these countries and the population at large will realize that minimal measures to reform a command economy simply will not work. Real substantive change is the best hope. The West can help through aid and technical assistance of the kind envisaged in the SEED Act and the Administration's proposal, and through providing opportunities for expanded market-based trade, but the bulk of the effort will have to stem from domestic reforms. We already are taking several initiatives in the field of U.S. trade and investment policy to normalize economic relations with Eastern European countries.

First, we are negotiating trade and investment agreements which will provide reciprocal assurances and protection for enterprises, traders and entrepreneurs, but which also will be effective instruments for advancing market-oriented reforms. The particular forms of agreements sought depend upon whether the country in question already has MFN status and whether it is covered by the Jackson-Vanik amendment.

Under Title IV of the Trade Act of 1974 ("Jackson-Vanik"), commercial agreements are required before we can grant most favored nation (MFN) status to Czechoslovakia, East Germany, and Bulgaria, as well as the Soviet Union. (We may also wish to revise our 1975 agreement with Romania as a condition of restoring MFN treatment to that country.) We also view these trade agreements as tools for removing significant barriers to commercial activity, for improving intellectual property protection standards, and for ensuring effective procedures for addressing market disruption resulting from import surges from these reforming command economies. The timing for initiating such negotiations with each country will depend on the pace and extent of democratic reforms.

Subsequent to the President's announcement of a one-year waiver of the Jackson-Vanik amendment during President Havel's recent visit to Washington, we agreed to initiate the process of Title IV trade agreement negotiations with Czechoslovakia. The elements of such an agreement are spelled out in Title IV and include reciprocal MFN treatment, support for trade promotion activities, protection for intellectual property, a market disruption provision, and a three-year term that can be renewed. I will be guided by the President's decisions on Jackson-Vanik in proceeding with negotiation of trade agreements with the other Title IV countries as well.

I believe it also would be useful to negotiate investment agreements with Eastern European countries (including Yugoslavia). These would contain the model Bilateral Investment Treaty (BIT) provisions and in some instances may need to be broadened to include other business facilitation assurances or to address characteristics unique to centrally planned economies in transition.

Key elements of our investment treaties are: the right to establish and thereafter to be treated on a basis no less favorable than the better of MFN or national treatment; binding dispute settlement procedures; international law standards for expropriation; and unrestricted transfers of funds associated with investments. In the case of centrally planned economies in transition, we would also require opportunities for competition for U.S. investors equivalent to state-owned enterprises.

In the case of Poland, which already benefits from MFN and GSP treatment, we are in the process of negotiating a Business and Economic Agreement. This agreement is composed of the model BIT provisions and, in addition, covers commercial activity, business facilitation and intellectual property rights. We have held two rounds of talks, in which we were guided by consultations with the Congress and advice from the private sector, notably the Investment Policy Advisory Committee (INPAC). Important issues, such as the right to repatriate profits, screening of foreign investment, the scope of third party arbitration, and adequate intellectual property protection are still outstanding. The third round of negotiations is scheduled for March 8-10.

We have explored informally with the Hungarian government negotiation of a similar agreement, since Hungary also already enjoys MFN status. Actual negotiations probably will await the election of Hungary's new government in late March.

Complete "normalization" of our trade relations with these countries, especially GATT members such as Hungary, Czechoslovakia and Romania, cannot occur as long as U.S. trade law (i.e., the Jackson-Vanik amendment) conditions the grant of MFN on satisfaction of statutory requirements. (These provisions do not apply to Poland and Yugoslavia, both GATT members, with which the United States enjoys full GATT relations.) Article I of the GATT requires unconditional application of MFN treatment to other GATT signatories. As a result, the United States invoked Article XXXV (non-application) of the GATT at the time of Hungary's and Romania's accession, and Czechoslovakia and the United States mutually suspended GATT obligations in 1951, an action which was subsequently sanctioned by a declaration of the GATT Contracting Parties.

As the democratization and economic reform processes in Eastern European countries evolve, pressures for full normalization, stemming both from their governments and from the U.S. private sector, will mount. From a trade perspective, integration of their economies into the world trading system, based on strict compliance with the requirements of the system -- adoption of price based mechanisms being the key -- is in the United States' economic interest.

SOVIET UNION

Let me turn briefly to the Soviet Union, where we also have the negotiation of trade and investment agreements underway. Initial trade agreement talks were held in Washington February 12 and 13. The basis of the agreement will be the elements required by Title IV of the Trade Act of 1974, including a safeguards provision dealing with threat of market disruption, intellectual property protection, and trade promotion. Nevertheless, we envisage an agreement which is broader than the Title IV requirements.

As you know, President Bush and Chairman Gorbachev plan to sign the trade agreement at their meeting in June. The second round of negotiations on the trade agreement are being held tomorrow and Friday. Bilateral Investment Treaty talks are scheduled for March 12 and 13.

Throughout these discussions we are remaining in close contact with the private sector and the Congress. We believe the Congress has a very important role to play in our relations with the Soviet Union and Eastern Europe, and I want to confirm the Administration's intent to work closely with the Congress as we negotiate trade and investment agreements with these countries.

EC 1992

The exciting changes in Eastern Europe and the Soviet Union should not prevent us from attending to the significant developments in Western Europe, where the European Community continues to make steady progress in its drive to create a single market by the end of 1992. The outlines of the single market have now taken shape, and many of the details have been filled in. The European Commission has tabled all but 18 of the 279 directives called for in the 1985 White Paper. Well over half of these directives have already been adopted into Community law by the EC's Council of Ministers.

On the whole, the single market is living up to its promise. It is being implemented in a trade expansionary manner that is creating new opportunities for both Europe and Europe's trading partners. Of course, a number of problem areas remain--some of which I will touch on today. We will continue to press the Community to address these issues in a manner satisfactory to us

-- either through bilateral channels or where appropriate in the Uruguay Round and other multilateral negotiations.

During 1989, the Community took a number of actions which eased the fears of many that EC 92 would result in new external barriers to trade. For example,

-- In the banking sector, the EC Council revised the reciprocity provisions of the Second Banking Directive to require national treatment in a manner which, we are confident, will permit U.S. banks to operate without discrimination in the single market.

-- In the transportation sector -- where substantial reforms are expected in air, road and sea services -- the Council dropped a proposed requirement that road haulage companies be majority-owned and controlled by Community nationals in order to compete for transportation business within an EC member state.

-- In the area of standards, the Commission agreed to undertake measures together with the European standards bodies to increase the degree of access for non-Europeans in the development of standards for the single market.

The reassurance provided by these actions has been tempered, however, by the Council's adoption in October of the Television Broadcast Directive, with a quota provision limiting access for foreign programs despite strenuous U.S. opposition, and the Commission's continued usage in antidumping circumvention cases of rule of origin interpretations that seem to create an artificial preference for EC products.

Let me touch on the latter in some detail because it relates directly to the issue before the Committee today. While not formally a part of the single market program, rules of origin can have an important effect on the degree of access for foreign firms to the single market. While rules of origin per se are not non-tariff barriers, they can become protectionist devices when they are unreasonably strict and/or interact with other trade restrictions or other trade policy actions to create a restrictive trade regime.

Certain EC rule of origin interpretations, in particular those applied to integrated circuits and printed circuit board assemblies (PCBAs), when combined with other trade policy actions (including antidumping measures) have had the effect of encouraging increased EC content in certain electronics products. A number of U.S. firms claim to have lost sales in the European Community as a result of these policies, and others feel under pressure to invest in otherwise unjustified manufacturing facilities in the EC. It has also caused uncertainty in the business community. As a result, certain downstream users of components apparently have switched from American to European suppliers simply to increase the "European-ness" of their products.

I have discussed this issue on several occasions with EC Commissioners Andriessen and Scrivener and have suggested a number of internationally acceptable approaches for resolving the PCBA origin problem. They have assured me of their interest in finding a solution to this problem for U.S. manufacturers. I plan to continue these discussions with Commissioner Scrivener during her visit to Washington next week.

Another area in which EC policies may affect U.S. firms' decisions with regard to locating in the Community is the automobile sector. We remain intensely interested in how the EC reconciles the strongly protectionist instincts of some of its largest automobile makers with the spirit of a competitive and open European market. The Commission is having a difficult time achieving consensus but seems intent on ultimately eliminating quotas on cars imported into Europe, although for a transitional period some restrictions in the form of a VRA with Japan are likely to be imposed on a Community-wide basis.

We have made our position clear: EC measures should not inhibit sales of American-built Japanese nameplate autos in Europe, nor should they act as an artificial inducement for U.S. auto parts producers to establish facilities in Europe.

At this point, I would like to mention briefly several other issue of importance to us at this juncture in the single market program.

One is the opening of EC procurement in the heretofore "excluded sectors". The Commission's proposal to establish procedures for open and fair bidding on government purchases in these sectors -- telecommunications, transportation, energy and water -- is expected to be adopted by mid-year. Just last week the Council of Ministers reached informal agreement on a "common position" on this directive. When implemented by the member states, it will open up vast new opportunities potentially worth billions of dollars. The question is whether American firms will have access to these opportunities on a non-discriminatory basis.

Our primary means of assuring fair and open public procurement is through the GATT Government Procurement code. If we are successful in obtaining Code coverage of these sectors, Signatories will be required to treat U.S. and EC content equivalently when conducting procurements, thus eliminating the discriminatory provisions within the proposal (50% EC-content in order to benefit from the competitive bidding procedures, and 3% price preference for European goods). Otherwise, U.S. firms may be shut out of these potentially lucrative markets.

Another area of concern to us is telecommunications. The Community is pushing forward on a controversial decision to ensure a Pan-European telecommunications market. The extent to which this internal liberalization is extended to foreign firms (both equipment suppliers and providers of services) remains to be seen. This will depend upon a series of decisions in upcoming directives.

We have made a good deal of progress in our discussions with the Community on telecommunications. However, much more remains to be accomplished. With that in mind, last week the President decided to rollover the period for negotiations provided for under Section 1370 of the 1988 Trade Act for another year.

Last year we made good progress in awakening EC standards bodies to the importance of involving outsiders in their standards development process. A key issue in 1990 will be the regime adopted by the EC for testing and certification. We need to continue to work to ensure access for U.S. products to EC testing facilities, and the acceptance of U.S. test data and certifications for regulatory purposes in the EC. The EC has already made clear it will seek a balanced situation with regard to advantages derived by EC products in the United States. In practice, EC products already have free access to U.S. product approvals. However, this may be difficult for us to guarantee, given the much smaller role of the U.S. government in industrial testing and certification.

Another area which continues to cause real concern is the increasing tendency of EC authorities -- both in the Commission and in the European Parliament -- to advocate the use of non-scientific considerations in the regulation of biotech products designed for animal, plant or human consumption. Our strong view on these safety matters is that regulations should be based on scientific evidence, and should not become closet means to affect social programs or impede trade -- as the hormone directive did last year, and as a threatened ban on BST (bovine somatotropin, designed to make cows give more milk) could do this year.

As I mentioned at the outset, the drafting of single market proposals has largely been completed. However, implementation of the single market directives by EC Member States is much less advanced. In many cases, it is difficult for the United States to judge the true impact of EC directives until the member states have actually implemented them. To that end, we have underscored to our embassies the importance of tracking implementation of EC laws. We'll also need the assistance of the U.S. business community in this effort.

Let me return to the developments in Eastern Europe for just a moment and comment on their impact on the single market. Many observers have asked whether the developments in Eastern Europe will slow the single market down. On the contrary, the changes in Eastern Europe may accelerate the process of economic integration within the Community. One of the central tenets of European thinking about German reunification, for example, seems to be that it can best be accomplished by a West Germany that is incontestably dedicated to economic integration within the Community.

The Administration will continue to support the single market program as long as it continues to be a truly trade liberalizing exercise that is open to U.S. firms on a non-discriminatory basis. We want to be sure that when trade barriers are removed within Europe, new barriers are not erected between Europe and the rest of the world. In our view, the single market should create a climate where direct investment by foreign firms is as welcome as trade but not required in order to share in the benefits of the single market. We will continue to work with the Community toward that end.

FOREIGN INVESTMENT IN THE UNITED STATES

Turning now to the third subject of this hearing, I would like to address the trade aspects of foreign investment in the United States, including the ramifications of a change in our investment policy for our international obligations.

Interest in foreign investment in the United States has grown in recent years in tandem with the increases in capital inflows. In 1988, the last year for which we have data, foreign direct investment in the United States was $328.9 billion, up 203 percent from 1981. Foreign portfolio and government investment amounted to $1,457.3 trillion, up 210 percent from 1981. This rise in foreign ownership of U.S. assets has led to concerns about U.S. policy toward foreign investment. Policy considerations, however, need to be firmly anchored in an understanding of the causes and consequences of the growth in foreign investment.

Understanding the growth of U.S. foreign borrowing in the 1980s, like the growth of our trade deficit, must begin at home. Quite simply, the United States experienced a sharp decline in national savings at a time of growing opportunities for private sector investment and sustained economic growth. The substantial difference between what the nation was willing to save and what it desired to invest was made up the only way it could be in an open global economy, by net capital inflows from abroad.

A few statistics provide some perspective. In the three decades before the 1980s, gross domestic investment in the United States averaged 16 percent of the GNP, while gross saving totalled 16.3 percent. This excess of savings over investment translated into net U.S. capital outflow or investment abroad. These thirty years of net investment abroad were the basis for the large U.S. net creditor position built up by the early 1980s.

Since 1980, gross private domestic investment - at 15.6 percent of GNP - continued near its historic norm. Gross saving declined sharply, however, to an average of only 13.8 percent of GNP, nearly two and one half percentage points less than its earlier historical average. The savings-investment gap, coupled with strong economic performance, acted as a magnet for foreign investment in the United States.

The impact of low domestic saving, of course does not end with high foreign investment in the United States. The net inflow of foreign capital provides the United States with the additional purchasing power to import more than we export in the trade accounts of our balance of payments ledger. In fact, through the accounting nature of our international balance of payments, the dollar value of the net foreign capital inflow should exactly equal the dollar value of the deficit in our current account.

When speaking to the issue of the trade deficit, I regularly point out that it is impossible to eliminate the U.S. trade deficit without closing the gap between our domestic saving and investment. And, it is preferable that the gap be closed through higher saving rates rather than reduced investment. The point is a similar one for foreign investment. Increased domestic saving would likewise reduce and eliminate the nation's reliance on net capital inflows, while assuring adequate domestic financing of strong investment in the U.S. economy.

I do not want to leave the impression that no progress has been made in reducing the trade and current account deficit and our corresponding reliance on net foreign investment in the U.S. economy. Our merchandise trade deficit has declined significantly from its 1987 peak, down 28.6 percent from $152.1 billion to $108.6 billion last year. Similarly, the current account deficit has fallen by 21 percent from a $144 million peak in 1987 to an annualized rate of $114 million in last year's first three quarters. Net foreign capital inflows have fallen correspondingly.

The problem is not one of foreign investment in the United States per se, but rather the need for large net inflows of foreign capital necessitated by low U.S. saving rates. The answer to the large net foreign capital borrowing -- like the answer to the aggregate trade and current account deficits -- is found in continued progress in sustaining the recent gradual improvement in U.S. saving rates.

New measures to restrict or discourage foreign investment in the United States are misguided because they result from a serious misdiagnosis of the problem. Not only would such measures create dislocations in our domestic economy, but they also would have serious repercussions internationally since access to foreign markets through foreign direct investment has important trade ramifications.

First, such measures would send a foreboding signal to our trading partners that the United States will treat foreign investors differently from domestic investors. Although investment is not now covered by the GATT, the principle of national treatment, that is, treatment at least as favorable as that afforded to nationals of the country, is enshrined in scores of treaties of Friendship, Commerce and Navigation and bilateral investment treaties between the United States and its trading partners. We have also made commitments on national treatment to our major trading partners through codes adopted by the United States at the Organization of Economic Cooperation and Development (OECD). To unilaterally adopt a mandatory reporting requirement or a reciprocity approach to investment would call into question these international commitments.

Second, restrictions on investment most likely would lead to reciprocal measures in foreign countries that could be used against our investors abroad. A spiral of restrictive actions that close rather than open markets could well ensue, with the net result of lower welfare for all.

Third, such measures would seriously hamper our efforts to open markets for U.S. investors in the context of the Uruguay Round of trade negotiations, scheduled to be completed in December of this year. A major objective for the United States in the Round is the negotiation of a multilateral agreement on trade related investment measures (TRIMs). Our goal is to discipline the continued and increasing use of government measures that are imposed as a condition for the establishment or expansion of investment. The list of TRIMS for which we propose multilateral discipline include the following investment requirements: local content; export performance; trade balancing; technology transfer and licensing; domestic sales; product mandate; local equity; manufacturing requirements and foreign exchange restrictions.

We have fought hard to have trade-related investment included in the GATT negotiations against the objections of several countries, both developed and developing, that prefer to keep investment fettered by government regulations. It would be impossible to promote a Uruguay Round position that seeks to liberalize these measures abroad if we were to impose investment restrictions at home.

Finally, these measures are not needed to ensure that important national security considerations related to investment are taken into account. The Omnibus Trade and Competitiveness Act includes the Exon-Florio provision that provides clear authority for the President to bar purchases by foreigners on national security grounds. He has exercised the authority provided by this law in a responsible way. There is absolutely no evidence of a need for further Presidential authority in this area.

I would like to close this section of my testimony by stressing that investment protectionism is at least as debilitating for the United States as is trade protectionism.

Open markets, freer and fairer competition, and ever-expanding trade and investment opportunities help the nation use our capital, labor, knowledge and natural resources in the most efficient manner. Freer trade and investment raise real output, real incomes and living standards and the economic growth rate of the country. It also is the most significant contribution that we, Western Europe and Eastern Europe can make to our mutual economic welfare. It is the Bush Administration's policy to promote these objectives, not only in our own legislation, but also in our bilateral relations with Europe and in the multilateral Uruguay Round negotiations.

Chairman Rostenkowski. Thank you, Madam Ambassador.

I recently wrote a letter to the President with respect to the implementation of trade agreements with the Soviet Union and other Eastern European countries. I am concerned, Madam Ambassador, with the fact that some members of the administration are suggesting that the Congress should be ignored in these agreements.

I am expecting, I hope, an answer within the very near future. Could you give me any idea of when I will get an answer to that letter? I would also like you to give me an idea of how you feel about whether or not Congress should be ignored with respect to the implementation of these treaties.

Ambassador Hills. I think we act as a partnership in this area, and I have every belief that the administration will work very, very closely with Congress on the United States-Soviet trade arrangements, as well as on other trade arrangements.

As far as the date that you will get an answer to the letter, I can only say that I will make inquiry. I am sorry if you have not gotten a prompt response.

Chairman Rostenkowski. Well I think that you are aware of the amount of esteem that is held by members of this committee with respect to your representing us in the trade area and how we feel about substantially raising the level of our Trade Representative. I do not know a member on this committee that does not feel that you should be a participant in all negotiations that take place, or that your office should be a participant in all of the agreements that are reached.

I think that we are in the decade, if not two decades, of enormously expansive trade and we are not going to be "big brother" any longer. We are going to be the competitor, as well. I just think that by having your presence at all negotiations that take place raises the image of what we feel and how we feel about trade. I think that is something that the administration ought to improve on.

Mr. Archer.

Mr. Archer. Thank you, Mr. Chairman.

We have had a number of bills introduced by our colleagues that would relate to foreign investment in this country. Some of them would ask for registration of foreign investment, some of them would ask for reciprocity if a foreign country denies free access to U.S. investors, that we should then reciprocate with like standards in this country, and I would like to get your comments on that.

Ambassador Hills. We are against imposing restrictions on foreign investment, even registration, because we believe it would invite our trading partners to impose like and even more aggressive restrictions on our investment, and we see no need for it.

We benefit from having an open market for investment. Some very thoughtful people, I think probably from the frustrations that are felt because of the very rapid increase of investment in this country, particularly by the Japanese, whose market is not as open as is ours, have begun to think in terms of reciprocity. We think that is also a danger, because reciprocity is not a standard we would urge upon the world trading system.

We would urge that markets worldwide be opened and be open to investment as well as open to trade. We have already committed in our general friendship, commerce, and navigation treaties and in a series of bilateral investment treaties, that we would give most-favored-nations treatment, so we cannot go back on those treaties. And were we to impose reciprocity, I am afraid that it would just catch us, rather than catch another nation.

I would rather work much harder to get other nations to open their markets and to adopt most favored nations, which is what we are trying to do in the Uruguay round negotiations on trade related investment measures. We want to get governments out of interfering with the free flow of capital, just like we want to get governments out of interfering with our trading relationships.

Mr. ARCHER. What tools do we have presently, and do we need any better tools to apply leverage on the Japanese to reduce their restrictions on foreign investment?

Ambassador HILLS. I think we have adequate tools, and we are certainly negotiating hard with our Japanese friends to open their markets, so that our investors and our entrepreneurs who would trade or invest would have the same access to their market as their investors and their entrepreneurs who trade have in our market.

The Japanese I think are more aware today than they have in years past that their prosperity comes from their capacity to trade freely and to invest freely. And if they continue to place limitations on entrepreneurs having the same opportunities in their market as the Japanese enjoy abroad, they will kill the goose that laid their golden egg.

We read in the Japanese newspapers and hear from various groups in Japan that they should open their market, they should become an importing superpower, they should be more forward-leaning in liberalizing their restrictions, and we are just working very hard at helping to make that happen. We do have adequate tools, if we must use them.

Mr. ARCHER. I have no further questions, Mr. Chairman. Thank you.

Chairman ROSTENKOWSKI. Mr. Gibbons.

Mr. GIBBONS. I am worried about the application of Jackson-Vanik. A number of the private witnesses here last week advocated repeal of Jackson-Vanik. They said it was an impediment to developing real business ties in other countries. Has the administration taken a position on this?

Ambassador HILLS. No, Chairman Gibbons, we have not taken a position. Our aim is to work with Congress and to negotiate the conditions that are now required by Jackson-Vanik to normalize our trade relations. Some of those conditions in the law we think are appropriate, particularly those dealing with the trade arrangements. The trade facilitation talks that are ongoing, we think make the climate for those that would trade with the Soviet Union or, indeed, other command economies, much more secure.

We are happy to consult with Congress on what would be the best legislative framework for dealing with the new opportunities that we have with respect to not only the Soviet Union, but also the various Eastern European nations that are seeking to extricate themselves from communism.

Mr. GIBBONS. I wish that you and the administration would take a look at that whole amendment and see what you feel is in the best interests of the United States and try to come to us with a united position. If you can, it makes it much easier to work together on this issue. It is a vexatious problem.

On another matter, let me first ask you about your position in the administration. I saw the other day that the President had designated you as being the chief to work out these agreements with Eastern Europe. Is that correct?

Ambassador HILLS. Yes.

Mr. GIBBONS. All trade agreements with Eastern Europe and with Russia?

Ambassador HILLS. That is correct. You know, our tiny little agency only has two functions. We coordinate trade policy within the Government and we negotiate trade agreements pursuant to that policy, and so the President simply restated the responsibilities that we already have to negotiate trade agreements with our counterparts and we will proceed to do so.

Mr. GIBBONS. Well, I congratulate you for having won his confidence in that regard and congratulate him for having had the good judgment to make that decision.

The next question I have is even broader than that. As I look at our Government and what we face right now, it looks like we have won two wars—the hot and cold—but it does not seem that we are very well organized to win the peace. We have not been so in the past and I do not believe we are now.

This opportunity that we have may not ever come again. As I look at your position—and you are the lead in winning this peace—and I look at General Powell's resources—and he sits there with hundreds of thousands of planners and logistical people to support his plans and you sit there with 156—I wonder whether it really ought to be the other way around.

I am not suggesting that you swap positions with him or swap staff with him, but it does not seem that we are adequately prepared to win the peace. Now, that is no reflection upon you and really no reflection upon the President, because I think peace has been thrust on us much quicker than we ever thought, but we will not have this opportunity again.

Is there something going on in the administration that I have not seen, am not aware of, in getting prepared to win this peace? It is going to be a long-range game.

Ambassador HILLS. I think we have a very good long-range team. You must understand that my responsibility is not programmatic; we are coordinate trade policy among all the departments and agencies and we work in a very inclusive way. When we develop that trade policy, we also develop teams to negotiate and carry out that policy, and we have borrowed and used and are working with people from every department and agency in Government, and I think effectively so.

Where we have made mistakes in the past, in my opinion, is where we have not been inclusive; where we have failed to use all of the talents that we have across the Government spectrum. So, even with the military and the Defense Department, we borrow good people from them. We have 31 detailees on a nonreimbursable basis, good and talented people who have wanted to come into the Office of the U.S. Trade Representative and are contributing mightily. So I think we have a good team to win the peace and we aim to do so.

Mr. **Gibbons**. Mr. Chairman, I do not want to abuse my time, but I want to come back on the next round and talk a little more about that.

Chairman **Rostenkowski**. Mr. Guarini.

Mr. **Guarini**. I will pass until next time. Thank you.

Chairman **Rostenkowski**. Mr. Levin.

Mr. **Levin**. Mr. Gibbons has talked about winning the peace. I assume that means competing effectively. Take Eastern Europe and Poland in particular, are you satisfied that 3, 4, 5 years from now the record will show that American business will be effectively active in terms of commercial relationships in Poland?

Ambassador **Hills**. I have no perfect crystal ball and I cannot tell you all of the things that Poland will do in the next 4 or 5 years, but I can say that we will negotiate a good business and economic agreement that makes Poland a more hospitable place for capital to flow.

There will be in the next 4 or 5 years and even in the next decade, in my opinion, a very harsh competition for international capital and those jurisdictions, which in the old days would have resisted passing measures such as protection of intellectual property, will have to do so if they want to secure investment of pharmaceutical companies, fine chemical companies, and the like.

There is a demand for capital south of our border and in Eastern Europe, and so I cannot tell you whether owners of capital will decide, whether it is going to flow more readily to Mexico or whether Poland will make that climate so hospitable that capital will flow there.

Mr. **Levin**. How about tools like export credits? It appears that already other nations are using that as a proactive technique and we are doing so in a rather halting fashion. Does that concern you?

Ambassador **Hills**. It is always useful for businesses to have credit, but were the climate more assured, then the banks and the private institutions would be willing more to give credit. We have a mechanism in this country that is less oriented by industrial policy than many other countries, but yes, I think that our businessmen can make hard-headed judgments about entering a country like Poland.

You must understand, even before this liberalization, we have had businesses go to the Soviet Union and invest, without any treaty security at all. It is difficult, but there are businesses that will seek out markets. We want to help them; we want to make it more secure for them.

Mr. **Levin**. This is one approach to level the playing field and leave it at that. That is one arguable policy. I have my doubts. I think it is too neutral, too passive, but time will tell.

On Jackson-Vanik, if the Soviet Union does not carry out its agreement regarding direct flights to Israel, should Jackson-Vanik be waived?

Ambassador **Hills**. I recall that we as a government raised with the Soviet Union, back last spring, the conditions required for most-favored-nations status. The President has now met with Secretary General Gorbachev, stating what the conditions are for waiver of most favored nations.

The Soviet Union is in its second reading of an immigration bill that would comply with the 1974 Trade Act. I think to change the rules now probably would be counterproductive, particularly since Secretary of State Baker has had discussions with his counterpart, Foreign Minister Shevardnadze, the problem of direct flights. I think we can handle this issue through a bilateral discussion, rather than condition it on these trade arrangements that are moving, I think, quite satisfactorily.

Mr. **Levin**. On foreign investment, I do not disagree myself very much with the spirit, but I am worried about the results. For example, we had testimony here last week or the week before that Japanese firms that come here import six times as much from Japan as is imported by non-Japanese by American firms.

You talk about national treatment, yet in the structure of impediment discussions, the Japanese can say they provide national treatment. They provide the same restrictive rules regarding, for example, retail distribution to their own companies as to the American companies. Is that an adequate principle, national treatment is enough of a defense? Why do we use it? We are not going to let them use it, when it comes to breaking through the immense barriers of retail distribution?

Ambassador **Hills**. The remedy for the Japanese market restrictions, which I think is what you are asking about, is to persuade them to buy on the basis of price and quality. They have had a tradition to procure on the basis of what is produced in Japan and we know that and we are trying to persuade the Japanese that competitive measures of price and quality are a better basis for appropriate procurement.

They have begun to import far more, and their companies that are located here have begun to establish buyer-seller relationships with our company here. We do not want to abandon the principle of national treatment. We do not want to copy their model of being more restrictive. We want to persuade Japan to be less restrictive, and we are making progress. They have a long, long way to go, and you are absolutely right about the Large Retail Stores Act, it is not aimed so much at foreigners as it is aimed at newcomers.

Mr. **Levin**. But it has the impact and, whatever its purpose, its impact is to keep out foreigners.

Ambassador **Hills**. Absolutely, and we are in the structural impediments initiative dealing with these imbedded structures that tend to have an adverse effect upon our ability to have the same access to their markets as they have to ours.

Mr. **Gibbons** [presiding]. Mr. Levin, we will come back to you.

Mr. **Levin**. Thank you.

Mr. **Gibbons**. Mr. Crane.

Mr. **Crane**. Thank you, Mr. Chairman.

Madam Ambassador, as we look to rewarding Eastern Europe for reforms thus far and with regard to the Soviet Union, there are a number of our colleagues who would waive Jackson-Vanik before they codify their immigration policy. Do you think it is appropriate to look at lifting some of the sanctions against South Africa?

Ambassador **Hills**. We have a law that sets down five conditions, I believe, that——

Mr. **Crane**. I think three have been met, have they not?

Ambassador **Hills**. They have met two, to my knowledge and there are five. Those five include, first, that they must release all political prisoners and Nelson Mandela from prison. They get half a score on that one. They have not released all political prisoners.

Second, they must repeal the state of emergency and release all detainees held under state of emergency. To my knowledge, this has not occurred.

Third, they must not ban the democratic political parties and permit South Africans of all races the right to exercise political freedom.

Fourth, they must repeal the Group Areas Act and the Population Registration Act; and, finally, they must agree to enter into good-faith negotiations with truly representative members of the black majority, without preconditions, and I am not in a position to tell you that those things have occurred.

I suspect that, as we evaluate what they do, that we will want to develop a consensus in this country that enough has been done. So, I guess my views would be to watch carefully and hope that they make rapid progress.

Mr. **Crane**. Are you sympathetic with waiving Jackson-Vanik before the Soviet Union codifies its position on immigration?

Ambassador **Hills**. There again, we have a de facto easing of immigration from the Soviet Union. I think 76,000 people immigrated last year, and it is not the same situation that it was years back. On the other hand, the Soviets are in the second reading of an immigration law that would codify these rights, and I would see no reason not to allow the process to proceed to have them enact that law. We do need to get the kinds of protections specified in the law for our foreign investors and those who would trade with the Soviet Union, protections which I think are quite sensible.

Mr. **Crane**. Getting back to a point that Sandy raised and that is the absence of an agreement between the Soviets and Israel on flights, my understanding is that the backup is literally months for people to get into Israel, and the absence of having that line of contact open, has that come up, to your awareness, in any of the discussions that we have had with the Soviets?

Ambassador **Hills**. I know that Secretary Baker has raised it with his counterpart. It has not come up in our trade negotiations, and I know that we are trying to get more direct flights, that we are supporting that initiative.

Mr. **Crane**. I have introduced a number of free trade agreements bills last year, in fact, with Japan, Korea, Taiwan and RCM countries and I know the sensitivity that the chairman feels about exploring that while the Uruguay round is in progress, and I am sure that you share that sensitivity.

Do you see any harm in Congress, at least the Members of Congress discussing it? It seems to me that it would add a little bit to your leverage in negotiations, if they thought Congress was entertaining the idea.

Ambassador **Hills**. I think that what we are trying to achieve is a free trade world through the Uruguay round and that if we take an area and create a special relationship in the next 300 days, it could be distracting and counterproductive.

Mr. CRANE. I do not mean you, but I mean if they were aware that the Members here were talking about it. Would that detract or add to your leverage?

Ambassador HILLS. I do not think it would help the current negotiations. It is important that they understand that we favor a strengthened multilateral system. Over the years, we have been a leader. We launched this round in 1986 and 4 years prior to its launching, we tried to launch an earlier round.

We have always been forward-leaning in liberalized trade and if we can achieve the reforms that we are seeking to achieve in this round, we will be better off than seeking reforms that are limited to one nation or one group of nations.

Mr. CRANE. Just one final quickie, Ambassador, and that has to do with Japan and the European Community seeking to, what appears to be, cut deals with the Eastern bloc countries. In your negotiations, are you committed to strict adherence to GATT guidelines? My concern is what is to prevent some of our trading partners in the European Community and Japan from running in there and cutting deals that disadvantage United States businesses if, in fact, we are trying to maintain that kind of standard where, ideally, we would like to see developed for one and all. In the interim, are you favorably disposed to permit a little flexibility?

Ambassador HILLS. First of all, I suspect you are talking mostly about Poland and Hungary. They are already members of the GATT and are bound by the most-favored-nations principle. Second of all, I think our hard-headed businessmen will strike deals that they think are in their best interests.

We cannot make them go to an Eastern European country if they feel that they are more advantaged by going to another part of the world. We just want them to have the opportunity to go, if it is in their competitive best interest to do so.

Mr. CRANE. Thank you very much.

Mr. GIBBONS. Thank you, Mr. Crane.

Mr. Cardin?

Mr. CARDIN. Thank you, Mr. Chairman.

Ambassador Hills, it is a pleasure to be with you again. I would like to follow up on the comments of Mr. Crane and Mr. Levin with regards to Jackson-Vanik for a moment, if I might. I am pleased with the testimony that you presented, that it is clear that the United States, in moving forward in negotiating bilateral trade agreements, is mindful of the human rights records and democratic reforms taking place in Eastern European countries.

I guess my concern is, on the El Al-Aeroflot agreements, that we have seen in the history of the Soviet Union numbers go up on immigration and numbers go down, and, obviously, these are different times and, obviously we are all extremely pleased by the changes that are taking place in the Soviet Union and look forward to normalization of trade relations with the Soviets under the Jackson-Vanik format, but we must be concerned that, since we have started this process, an agreement was entered with Aeroflot and El Al that is now not being carried out, because of the political pressure put on the Soviet Union by some of the Arab countries.

The Jackson-Vanik law speaks to the right or opportunity to emigrate, and clearly the codification of their immigration statute will speak to changes in the right of a person to emigrate from the Soviet Union, but if they cannot get out of the Soviet Union because there are no flights, then the opportunity is being denied.

So, I guess my question to you is, we want to move forward in this process and I understand the negotiations that have taken place and we have seen some remarkable changes occur, but I just want to encourage you, as you go through these procedures of negotiations, that we have ways to monitor that, in fact, what the Soviets are advertising will, in fact, take place, and one way to assure that would be the direct flights between Moscow and Tel Aviv.

I would appreciate your comments on that. I know the administration has been very strong in its commitment to Jackson-Vanik, and now that we are so close, it seems to me that we have an opportunity to make that further advancement, that we should not lose that opportunity.

Ambassador HILLS. I do not think we would lose the opportunity by having the Secretary of State raise it with the Foreign Minister as an issue of concern. I think in these trade negotiations, which we started some time back, laying down the conditions of the negotiations, that we ought to proceed, and to have this political discussion take place separately. I am sure that the Soviets are aware of our concern about access, of direct flights. There has been no limitation of indirect flights or going through a third country.

Mr. CARDIN. I might point out, though, that there has been a change since we started the negotiations in that. We thought that there would be an agreement carried out, but since we started the negotiations, the Soviets decided, because of political pressure, not to implement an agreement that I believe the United States and certainly Israel thought would, in fact, be carried out. So, we are not changing the rules, I would submit that the Soviets are changing the rules and that we should be rather strong in pointing that out through the process of negotiations.

Ambassador HILLS. We have been quite strong in making our position clear. As you are quite well aware, the Soviet Union is beset with many political problems today, and I suppose most governments have to organize their priorities in dealing with their political problems. We have made them aware of this concern of ours, and we will continue to do so. I am glad to have your point of view.

Mr. CARDIN. Thank you.

Let me move to a second point. We have had some comment about the preparedness of companies in this Nation to take advantage of opportunities that are occurring in Europe. Obviously, we must wait at least to a certain degree until the negotiations of treaties and trade agreements, in order to protect U.S. companies in their commerce in Eastern Europe and Central Europe.

I guess my question to you is, are there other things that we could be doing so that the private sector could be better prepared to meet the competition and challenges of getting into Eastern Europe, as far as the commerce is concerned, in light of what is taking place among our competitor nations?

Ambassador HILLS. The private sector is visiting the Eastern European countries and the Soviet Union, and they have been investing. They did not cease investing in the Soviet Union when we did not have an arrangement. Where our entrepreneurs make a calculation that such an investment is in their company's best interests, they have invested; and they have traded to a certain extent. We do have trade with these countries, even though it is much smaller than it might otherwise have been, had they not been overtaken with command economies. We will try to make the atmosphere even more hospitable through the protections of trade agreements and subsequently through investment agreements, that will encourage those who would otherwise not have ventured forth.

I think that is what we can do. We cannot tell our industries that they must go; we can only try to make the opportunities as good as possible, under the legal regimes that they have.

Mr. CARDIN. Thank you, Ambassador Hills.

Mr. GIBBONS. Thank you.

Mr. Downey.

Mr. DOWNEY. Thank you, Mr. Chairman.

Ambassador Hills, I missed your response to Sam Gibbons' point on Jackson-Vanik and you have alluded to it here before. The administration does not have a position on repeal of Jackson-Vanik, am I correct in that statement? Is that what you said, that you did not have a position on its repeal?

Ambassador HILLS. I would say that we are proceeding with Jackson-Vanik, to try to carry out its mandates, which are two, namely getting a liberalized immigration codification from each of the countries involved and by negotiating the 10-point trade agreement that is required by the Jackson-Vanik amendment.

Mr. DOWNEY. I think my concern is for the businessmen and women who are attempting to do business in the Soviet Union. I, along with Senator Moynihan and several other members here, have proposed a waiver of Jackson-Vanik. The businessmen and women are concerned about a definite time period that they would like to have for certainty of doing business, a 3-year period or a 5-year period. What is your view of that?

Ambassador HILLS. I think after we get the necessary agreements, then we can consult and decide whether we are best served by a repeal, a longer waiver, how to handle it. Events have moved very rapidly. Change has been rather dramatic. But we do want to negotiate agreements which will provide maximum protection for our entrepreneurs. The trade agreement, which are really facilitation agreements, help our entrepreneurs get into trade. The trade agreement does not deal with investment.

I would think that after we have a trade agreement, we would probably engage in negotiations on a bilateral investment treaty, which we have with a number of countries, so as to protect against expropriation and guarantee fair access to raw materials, distribution systems, and the like. I think we are moving in a prudent way and I would be very happy to consult with you, when you think it is time for us to take another position.

Mr. DOWNEY. You would then encourage business not to be concerned about whether a year or 3 years or a repeal of the waiver have not been addressed yet, but that they should go ahead and proceed with the belief that this is something that the administration is working on, that we are looking at a long-term relationship here with the Soviet Union?

Ambassador HILLS. We certainly are looking for a long-term relationship, but we must understand that not all of the cards are in our hands——

Mr. DOWNEY. I understand that.

Ambassador HILLS [continuing]. And things can again turn around as rapidly as things have turned around in the past, and we want to be careful.

Mr. DOWNEY. Sure.

Ambassador HILLS. Business decisions should be made on commercial reality, they should be hard-headed and not on an altruistic basis—and that is what businessmen are generally quite good at.

Mr. DOWNEY. I was about to ask you when you found them to be more altruistic than hard-headed, but that would probably be a brief discussion.

Let me ask you about ruble convertibility, if I could. What kind of arrangement could be included in the agreement that would promote, in your opinion, freer repatriation of American profits? Are we talking about enterprise zones, other possible forms of exchange agreement, where people can look at repatriation a bit more sanguinely?

Ambassador HILLS. First of all, in all of these agreements, we are looking for equal access to hard currency and we do not want any discrimination, we want most-favored-nation treatment.

Second of all, some of these arrangements are going to have to be negotiations business by business, as to how they are going to secure the hard currency. There will be some financial arrangements; we cannot underwrite every business transaction, by any means. Providing reliable money, as well as providing for private ownership property I think are two conditions precedent to moving along the path toward market-oriented economies.

Mr. DOWNEY. Do foreign economic zones play a role in any of this, from your perspective, which would include provisions for foreign companies investing in the Soviet Union as part of the convertibility?

Ambassador HILLS. We can explore those. Several nations have used that device.

Mr. DOWNEY. Let me ask you, generically. You mentioned before, I think to Mr. Crane, he has a proposal for free trade zones with other countries, which is an interesting idea, but the sense is that you are proceeding with GATT and you want to negotiate this in a multilateral way, and I appreciate that.

But how would you respond to the point that we have had two experiences with free trade zones, one with the Canadians and the other is with the Israelis, that seem to have worked very well. We do not exclude, do we, as we talk in the GATT round, with the possibility with other nations in a bilateral way of developing free trade zones, do we?

Ambassador HILLS. No; the GATT makes provisions for free trade, if it covers all of a country's trade and it does not pick and choose. But I think my point here is we have fewer than 300 days left to negotiate the multilateral system's rules. We have a trillion dollars of trade taking place today, a trillion dollars, that is a third of world trade takes place, with no multilateral rules. Agriculture is inadequately covered; services, worth $560 billion a year, are not covered at all; investments, intellectual property, not covered at all.

I think it is very, very important that we not deal with getting such rules with one country, but we must get them with our 97 trading partners. To stop at the third year-plus of our multilateral negotiations to engage in a brandnew free trade arrangement would be quite difficult. Also I would think that before we engaged in one, that we would want to consult, because there are differences of degree of difficulty, depending on the nature of the economy of the partner with whom we might engage in a free trade arrangement.

Mr. DOWNEY. Thank you, Ambassador.

Mr. GIBBONS. Thank you, sir.

Mr. McGrath, and then Mr. Pickle.

Mr. McGRATH. Thank you, Mr. Chairman.

Welcome, Madam Ambassador. Let me weigh in with an opinion on I guess the subject that most of us have weighed in on and that is Jackson-Vanik. My own personal opinion at this particular point in time would be that should the administration choose, I think a wiser choice would be for an extended waiver, rather than a repeal, in light of the tenuous nature of the events in the Soviet Union at the present time.

Now, having said that, let me get on to another subject. We had extensive hearings in the committee regarding EC 1992. One of the great complaints, of course, among those who testified was the unevenness of the playing field, in terms of taxation. We have taxed in the Tax Reform Act our domestic companies differently in different countries in the European Community.

I guess the threshold question would be if they are going to consider themselves as one, why can we not consider ourselves as one in doing business over there. I am just wondering whether or not—I guess timing is the issue, they would like us to change our tax laws now in order to accommodate this evenness or levelness of a playing field. I am just wondering whether or not you feel that we should do it now or wait until we see what happens with EC 1992, come 1992 and years after. Should we change our tax laws now or should we just leave them alone and see what happens, this timing issue?

Ambassador HILLS. I would really want to consult with our Secretary of the Treasury, since tax is in his portfolio, and indeed, the chairman has told me that he is coming up here to testify in these hearings that you have opened in April. I really have not considered the appropriate timing or even the content of a change in our tax laws, but I would be glad to look into it.

Mr. McGRATH. Those who testified said that the changes in subpart F that we enacted in the 1986 law created a problem for them in dealing in Europe, and it seems to me that if we are going to have that half-full glass of water, rather than half-empty when this comes along, that perhaps we should be changing our laws to allow our domestic companies to compete on a better basis, but I am wistful in terms of whether or not it should be now or wait and see what happens. I just wanted to share that with you.

Thank you so much for coming.

Mr. GIBBONS. Just a little footnote. We have introduced that bill today, you and I, so it will be over there for you to ponder.

Ambassador HILLS. Thank you.

Mr. GIBBONS. Mr. Pickle.

Mr. PICKLE. Thank you, Mr. Chairman.

Madam Ambassador, when you met informally with our committee recently, I emphasized to you the importance of enforcing 301 and you said that you thought that was an important factor to consider. You said that you had six cases, as I recall it, where you actually were considering following 301 and you were going to furnish me with a list of those instances. I have not received that list. This is a means of just reminding you that I would like to see that list.

Second, I would like to ask you, when you say that you are considering three cases—I do not know whether they are all against Japan or other nations of the world, but does that mean that you have served notice on them that you are going to enforce 301, or that you have just kind of started the clock running, or what does it mean?

Ambassador HILLS. We follow the statutory procedure. Last spring, we filed our national trade estimates report, which listed all of the trade barriers, legal and illegal, around the country and we are required by statute, 30 days after the filing of that report, to identify our trade liberalization priorities for the year. We did identify Japan for three practices, Brazil for one, and India for two. Those are the six practices. That identification starts a negotiation with our trading partner and an investigation of the facts, to be sure that we are accurate in our views of the practice. By statute we have a year, through June 16 of this year, in which to complete the negotiations and the gathering of facts with regard to the practices which seem to us to be a problem.

Mr. PICKLE. So, in approximately 4 months or thereabouts, you will know whether you will proceed under that section or not?

Ambassador HILLS. We feel that once we designate the priority that we are in the process—when you say proceed, I take it that the statute contemplates that we negotiate hoping to accomplish our end of either opening the market or getting a fair rule in the area, and that is what we are in the process of doing.

Mr. PICKLE. You indicate to me that you do not like reciprocity, because you are trying to appeal to the Japanese to open up their market, because if they do not, we take that action and that means our market will be closed to them and we are going backward, instead of forward. It seems to me, though, you are putting the burden of proof on us and not on Japan. How are you going to appeal to them, send them a Valentine?

Ambassador HILLS. We do not only trade and invest with Japan. We have enormous investments all around the world, including the 97 trading partners in these ongoing negotiations and we are trying to persuade them not to use restrictions on our investment right now.

Mr. **Pickle**. And how are you persuading them? I would like to hear that you are going to persuade them, you want them to be nice people, but they are not always that nice in the trading field.

I do not want to be unfair about it, but we have given you a weapon to use. I do not look at is as a weapon, but just as a means of having some kind of reciprocity and if it is not enforced and you do not use it, then it seems to me like you are misinterpreting our intent here.

Ambassador **Hills**. The way I read your intent, Mr. Pickle, is that you want to have free opportunity for our investors to invest anywhere they want to around the world, and we are obtaining agreement to that end with countries around the world. Indeed, this is a subject of our negotiations in the Uruguay round.

Mr. **Pickle**. Madam Ambassador, I do not want to form an unfair opinion here, but it seems to me like you are more interested in having their trade and their investment practice over here than you are enforcing 301. Is that an unfair appraisal of it?

Ambassador **Hills**. I do not know how we could use 301 right now, with these negotiations. We are negotiating for open investment. Indeed, we did use 301 with respect to investment in India.

Mr. **Pickle**. Well, I notice one of the controversies brewing now is the case of Boone Pickens, he had gone to Japan and he had made an investment and apparently is a majority stockholder over there, but he cannot get a seat on their board. Now, I do not know the facts involved, but he cannot even be a partner over there, even when he is the majority owner. Are you familiar with that case and the problem? Why is it that he cannot be recognized as an investor over there?

Ambassador **Hills**. Well, he is an investor but he does not have a seat on the board. I have met with Mr. Pickens. He has said to me that he did not want us to take action and we are apprised of his situation. We have mentioned to the Japanese his circumstance as an illustration of our perception that their market for investment is not open.

Mr. **Pickle**. Well, it ought to be a two-way street, they ought to be willing to accept our products, if we accept theirs, and that is such a simple approach to me. Now, they tell me that you have got problems in the field of banking and investments and maybe that is a little different. I want to know a little bit more, why it is different, and I will be talking with you later, either in this round or another time. It seems to me that the principle is sound and we ought to enforce it.

I thank you, Mr. Chairman.

Mr. **Gibbons**. Thank you, Mr. Pickle.

Mr. Guarini.

Mr. **Guarini**. Thank you, Mr. Chairman.

Madam Ambassador, welcome again.

Ambassador **Hills**. Thank you.

Mr. **Guarini**. The prospects of East and West Germany getting together are very great and is happening in lightning speed. A unified Germany may well dominate the Common Market and I think there is no doubt that Germany is the strongest segment in Eastern Europe, as well as in Western Europe. How are we planning for this eventuality? It is going to mean so much to the balance of power and so much to trade. Are we making any plans or arrangements to prepare for this imminent reunification?

Ambassador Hills. I think you are correct, that Germany is now the largest and most powerful of the 12 member states in Europe. If they adopt East Germany, that will add about 20 percent to their size. It will also add considerable debt and challenge to their agenda.

The European Community has, I think, signaled to Germany that it would welcome the GDR as part of Germany, and we would deal with that unit just as we deal with Europe, the European Community now, carefully and with vigilance. Our interest is that we do not permit them to erect exclusionary rules that adversely affects us.

Mr. Guarini. But are we discussing anything with them? As soon as they get together, according to the Wall Street Journal and many economists, there is going to be a rise in inflation, interest rates, is it going to have an effect on our borrowing money from abroad, if interest rates go up? Are we just watching what happens, or are we participating in any way in the process or preparing for what will happen?

Ambassador Hills. Well, you know that President Bush met with Chancellor Kohl over the weekend. I think that we are quite knowledgeable. It is not our place, in my opinion, to stop the unification. Things are happening very rapidly in Eastern Europe and we do applaud their march toward market-oriented policies. We are grateful that the cold war has come to an end and that people are having a choice as to the economic system and the political system that they want to embrace.

So, it is not a question of sitting by. As you say, the unification seems to be proceeding rapidly and I think we have tools with which to deal with the European Community, of which Germany is a very prominent part.

Mr. Guarini. According to your statement, I understand that you perceive that Eastern Europe will be part of the common community some day, that we may have one large common community in the future, that they will gravitate toward the EC. Is that a fair statement?

Ambassador Hills. I have not made that statement, but that is a possibility.

Mr. Guarini. I thought I picked that up in your statement.

Ambassador Hills. What we would like to do is to build out our multilateral system so that these nations in Europe have the stability of being part of a real world trading system that provides rules for market-oriented economies.

Mr. Guarini. That will be a very powerful economy, with 480 million people and a gross national product that would almost approximate twice ours and the potential that it has. Are we doing anything to show some of these Eastern European countries how to privatize, how to decentralize, how to convert their currency? Are we giving them any technical assistance and advice as to how to redirect and retarget their skilled labor into the proper kind of industries where there is distortion that exists presently? Are we actively involving ourselves at all, or would that be more the Department of Commerce?

Ambassador HILLS. Well it has been an intergovernmental effort. It clearly is beyond the 200 people that we have at the Office of the U.S. Trade Representative, but we are aware that a number of trade missions have gone with Cabinet-level people, including Clayton Yeutter, the Secretary of Agriculture, and Bob Mosbacher, the Secretary of Commerce, Elizabeth Dole, the Secretary of Labor, Michael Boskin, the Chairman of the Council of Economic Advisers——

Mr. GUARINI. So, we are working with these countries?

Ambassador HILLS [continuing]. All trying to give technical assistance in their particular areas, and we have had teams of technically trained people in Eastern Europe.

Mr. GUARINI. I imagine one of the big problems we have is convertible currency in trading and, of course, that leads to countertrade. Do you foresee in the Uruguay rounds any expansion of the principles or rules and regulations concerning countertrade? And what do you envision as countertrade playing a role in convertible currency, in lieu of convertible currency, to try to develop trade with these Eastern European countries?

Ambassador HILLS. Of course, to achieve a convertible currency, you must achieve a certain strength in your economic system, and I think that is what is important to establish now for these countries.

Mr. GUARINI. So, until then, they use countertrade, possibly?

Ambassador HILLS. They are mainly trading with a very few nations—and barter, of course, is being used by some. But direct trade is also being used. We have a direct trade with the Soviet Union, which is by anyone's description, still a command economy. There is no private ownership of property and there is no ready convertibility of the ruble.

Mr. GUARINI. Lastly, just let me ask you, without imposing on the time, do you envision that there will be more bartering, more countertrade that will be utilized in the near future, and do we have GATT rules that will be explicit in this regard?

Ambassador HILLS. We do not have GATT rules that deal with barter. Barter will not be, as you said, increased in the future more than it has in the past. I think the Eastern European nations and the Soviet Union have, to a large extent, engaged in barter amongst themselves.

Mr. GUARINI. Thank you very much.

Ambassador HILLS. Surely.

Mr. GIBBONS. Mr. Thomas?

Mr. THOMAS. Thank you, Mr. Chairman.

Madam Ambassador, would that your budget reflected your perceived responsibility area, you would be awash in money.

A narrow question on the German unification, and I want to know if it is of concern of the greater good subsumes the concern, and that is, I understand our dealings with Poland and Czechoslovakia and everyone else on a nation-to-nation basis and multination basis. To me, the East Germany-West Germany is kind of unique and I believe that events are moving relatively rapidly in a monetary union and a political union.

I do not know that the complete economic integration will move as quickly, that is, Eastern Germany will be engaging perhaps in some production that clearly cannot be defined as market or you could not put some ordinary market economy value on what they do, yet it is going to move into commerce as German and whatever that unification phase will be. Do you have some concern about that, in terms of potential dumping or undervalue or inability to determine value? And have we thought about that, or is that too small a concern, in terms of the greater good that obviously comes from the unification?

Ambassador HILLS. In general, we do have rules of how to implement dumping with nonmarket economies. We have proxy prices, so that we deal with them in a different way.

The face of Eastern Europe is changing very rapidly. I cannot tell you whether, if there is a de facto and de jure German unification, so that we will be dealing with one Germany, then we will have a market-oriented country. In effect, Germany will underwrite and provide financial stability to that which they adopt. We just do not know what is going to happen, but I do think we have the tools and the capacity to deal with the eventualities.

Mr. THOMAS. One last nail in the Jackson-Vanik coffin, so that I fully understand where we are. Was I correct in perceiving that the administration, in terms of alternatives, would perhaps like to keep the current structure, because of the requirement for the immigration, and especially the trade agreements, rather than, for example, standing Jackson-Vanik on its head, in terms of the suspension of Jackson-Vanik, unless the President indicates to us that we ought to impose it? Would that be a preferred structure, or do you like the current one, in which you could have the Presidential ability, plus the mechanics of the specifics to deal with, if you want to?

Do you understand my question?

Ambassador HILLS. What we would like to do is to complete the trade agreements which we think are necessary and to have the immigration laws passed, as we think is possible, and that provides stability. Then we can decide what to do with respect to our long-term plan.

None of these countries have market-oriented policies in place, so that we do think that proceeding as we are, with alacrity is wise. We have five negotiations ongoing; we ought to complete those negotiations, accomplish these goals, and then consult with Congress as to whether repeal is appropriate or some other measure.

Mr. THOMAS. I will try it again. You believe that, in the short-run, under the current negotiations, the specificities required under current law could actually work to our advantage in the short-run, rather than our disadvantage in getting out of these folks a step-by-step requirement under the law of agreements that perhaps otherwise would not be as clearly negotiated in a time-frame?

Ambassador HILLS. That is quite possible. I do believe that to have the stability of not changing the legislative framework, since we are already engaged in negotiations, is perhaps useful.

Mr. THOMAS. Has anyone in recent days at GATT discussions begun to try to create the argument of the degree and rapidity of change in Eastern Europe as a possible reason for slippage on any of the closure dates?

Ambassador HILLS. Oh, I suspect that there have been comments of all sorts in the halls in Geneva, but we are committed to complete these negotiations by December 1990, as scheduled.

Mr. THOMAS. So, you do not feel that any of the folks we have had those long serious negotiations with believe that the change in Europe, the influence on 1992 and the rest of it has really significantly or structurally affected the timetable that we are on on GATT?

Ambassador HILLS. No; it has not affected our timetable. I cannot tell you that other partners would not like to let it lapse, but I think that would not be either in our best interest or in the best interests of the overall negotiations.

Mr. THOMAS. OK. Back to the original question. You have not had any indication that they have begun to possibly lay the groundwork for using that as an excuse?

Ambassador HILLS. No; no such indication.

Mr. THOMAS. Thank you very much, Mr. Chairman.

Mr. GIBBONS. Mr. Russo.

Mr. RUSSO. Thank you very much, Mr. Chairman.

Ms. Hills, let me just mention two things that I am concerned about in the Uruguay round. Inverted tariffs, as you know, is something I am very concerned about. I certainly hope that when we get the tariffs on input products, they will be less than the tariffs on the end products. I certainly hope that something can be done.

The antidumping laws, there are rumors that we are prepared to weaken our antidumping laws, so I just want to raise those concerns, because as one who sat on this committee in 1979, trying to fight for more reciprocity, I certainly hope that we do not weaken these laws.

Any comment on those two things?

Ambassador HILLS. We do not intend to weaken our antidumping laws.

Mr. RUSSO. Let me ask about an article that you are probably not too happy about. When I read articles about myself in the newspaper, I am never too happy about it, either. I do not believe everything I read in the newspapers.

As somebody who has been on this committee since 1979 and who does not believe, as Mr. Gibbons and maybe Mr. Downey believe, in free trade, I happen to believe in fair trade and reciprocity. It seems to me some major concerns were raised in the Wall Street Journal article which was critical of the staff and the negotiating team that is dealing with the Japanese.

I have read your comments and I understand how you feel about it and I believe everything you say in the article, but I think the American people need to be assured that this negotiating team that is negotiating with the Japanese really and truly acts in the best interests of the American taxpayers and American companies.

Since I have been on this committee since 1979, we have been trying to open the Japanese markets to our products. We have not been successful, as far as I am concerned, in really doing the job that we need to do, considering the amount of trade that the Japanese do in this country. I have a very easy solution to deal with that, obviously, but I am not the United States Trade Representative, nor am I the Secretary of the Treasury.

But can you assure this committee and the American people who are going to rely very heavily on your judgment and your negotiating skills that the best interests of America come farther ahead than some of the people that were represented by some individuals on your negotiating team?

Ambassador **Hills**. We have a first-class negotiating team, Mr. Russo, and we have a team that is made up of fine people across Government. They all have talent, they bring expertise, they are hard negotiators, and I think that we have accomplished a good bit with all of our trading partners in the past 12 months.

Mr. **Russo**. Well, I am more concerned about the Japanese than anybody else, because when the Japanese twitch, something happens to us in this country. They raise their interest rates and our interest rates go up.

Let me just quote from that article a statement by Senator John Heinz. He says, "It is a national tragedy," says John Heinz of Pennsylvania, a Republican. "So many people who once worked to further the national interests go to work for Japan. In Japan, anyone doing that would be ostracized for life." And the article goes on to say, "In fact, it is rare to find any former Japanese trade official advising U.S. companies. Moreover, Japanese law actually prohibits the country's lawyers from working for foreign law firms."

Now, what I am concerned about is the appearance of impropriety, which we all deal with. Those of us in Congress who get campaign contributions, who get honoraria are always told that we are being influenced by it. So, I am just concerned about the potential impropriety. I am not saying it exists. But when we have been fighting for all these years to open up the markets, and I see the President of the United States go and get a $2 million honorarium, it kind of makes me wonder what our Japanese policy was during the 8 years he was President.

We went from the largest creditor nation in the world to the largest debtor nation in the world in those 8 years. Interest rates are set artificially high today and consumers have to pay a high rate of interest, only because we have to make sure that the Japanese and West Germans come into our bond markets and buy our bonds, otherwise interest rates would be down to 6 or 7 percent.

The Japanese are beginning to own more and more of America and own more and more of our national debt. About 4 percent of our national debt is now owned by the Japanese. As one member who is not a big lover of the way things have been handled with the Japanese, when I read an article like this, I just want to assure myself that the job that you are going to do is going to take into consideration the needs of this country and that you will be as tough with the Japanese as you are with any other country.

I have no reason to believe that you do not. I am just trying to make myself feel a little bit more comfortable, not that I do not trust you. I want to make it very clear that, whatever happens with Japan, we had better make sure we open up their markets or there is going to be a big protectionist wave in this country to deal with the problem.

Ambassador **Hills**. Let me assure you, Mr. Russo, that I am representing the American interests and that if you look less at rumors regarding what friends we may have or who we may have spoken with, and more at the results that we achieve, you will get a better picture of what we are doing at the Office of the United States Trade Representative.

Mr. RUSSO. Well, I am not necessarily criticizing you, Ms. Hills, but I have been working at this for 10 years. I have seen it happen through different administrations. Whether it is the Carter administration or the Reagan administration and now the Bush administration, it is the same story, we cannot crack the marketplace.

Ambassador HILLS. We have made some progress. We have a lot more progress to make, but we have had some successes and I will——

Mr. RUSSO. I understand that and it is in the Japanese interests, if they are wise to at last open up some of their markets so that people like you can come back and—I am not saying this in a negative way—come back and say we made progress.

But given the openness of our market to their products, there is not this reciprocity and I think it is very disturbing to constituents out in the district where I come from, where steel is no longer in my district, autos are going downhill, textiles are going downhill—we are having severe dislocation in our part of the country and all we have to show for it are a few victories.

Now, granted, you have probably made more strides than most other people have made in the last 10 years I have been on this committee, but that is not saying a lot, considering the access they have to our marketplace. I mean there are simple solutions that can be offered to the Japanese.

For example, if they import 3.5 million cars a year in this country. Well, next year it is going to be 3 million cars, after that it is 2.5 million cars and after that it will be 2 million. Until they open up their marketplace, we are going to shut down their access to ours. It seems too logical to deal with that, but why do we not use that as a strategy? They do not let us into their marketplace. Why do we not deprive them access to our marketplace?

Do you want to comment on that?

Ambassador HILLS. No.

Mr. RUSSO. OK. Well, I certainly hope that, in your tough negotiating session, they understand that the Congress is getting tired of the games that they play, not the games that you play, but the games that they play. And Sam Gibbons, as strong as he is a free trader, eventually he is going to see that maybe being such a staunch free trader does not open up enough markets for us. And God help them if he ever decides to change his stripes. [Laughter.]

Mr. GIBBONS. Mr. Pease and then we go to Ms. Johnson.

Mr. PEASE. Thank you very much, Mr. Chairman.

Madam Ambassador, it is very good to have you here. I was absent during your testimony, but I have had the chance to read it all and it is excellent testimony.

You are currently negotiating or will soon start to negotiate a number of trade agreements with Eastern European countries in relation to MFN status. If no one has asked you yet, may I ask you, what is your intention or the intention of the administration regarding approval of those trade agreements once they are negotiated? Do you intend to submit that to Congress for the approval of Congress?

Ambassador **Hills**. We will work very closely with Congress in developing these agreements, and my understanding is that there is a proposal to fix the constitutional infirmity of the 1974 Trade Act, which would require concurrent approval of the trade agreements, to require joint resolution. As I understand it, that is perfectly satisfactory, with the administration.

Mr. **Pease**. Would it be your position that you could not submit the agreements to Congress for its approval, unless the Chadho decision is fixed?

Ambassador **Hills**. Well, the case held that that part of the statute which required a concurrent resolution is unconstitutional. I think there are lawyers who would say that it was not, therefore, required to come to Congress, but the philosophic bent of this administration is to work closely with Congress. I personally would want to consult with you on the content of the agreement. I am told that it is the view of the administration—which I heartily endorse—that if there is this amendment for "joint" instead of "concurrent" resolution, that we would abide by that process.

Mr. **Pease**. The administration would support that change, is that correct?

Ambassador **Hills**. That is my understanding, yes.

Mr. **Pease**. In case we do not get around to changing the word "concurrent" to "joint," through a technical amendment, what would be the position of the administration about submitting the agreements to Congress for approval via joint resolution, anyhow?

Ambassador **Hills**. You mean a free-standing joint resolution to approve it?

Mr. **Pease**. Yes.

Ambassador **Hills**. Well, that would be another way to go, the same sum and substance, in effect.

Mr. **Pease**. Well, I am trying to pin this down. If the Chadho case is not fixed by a change of the statute from concurrent to joint, is it the intention of the administration to implement the agreements, without congressional action, or will you seek some sort of congressional action going beyond the consultation that you have mentioned?

Ambassador **Hills**. You are suggesting that Congress would not be willing to make the correction and——

Mr. **Pease**. No, no, not at all. We just may not get around to doing it and I——

Ambassador **Hills**. I think at some point there will be a consensus in Congress that these trade agreements that the business community needs to have to feel secure in Eastern Europe and in the Soviet Union. We hope that there will be a desire to have these agreements implemented, and we will consult with you. I would hope that we will not get into the difficulty of having Congress decide that this is a low priority in one committee and mandatory for great expedition in another committee. Surely, we can agree on this.

Mr. **Pease**. Surely. Could you give us a roundup of the status or possible status of GSP for the various nations of Eastern Europe?

Ambassador HILLS. GSP is conditioned on most-favored-nation status, so that comes after we get through the 1974 Jackson-Vanik requirements. We will look very hard at those things that we can do.

Now, the President has already acted with respect to Poland and in Hungary, we are already undertaking a special regime of GSP and looking at those things that would be advantageous to them. That is also true of Yugoslavia.

Mr. PEASE. Do your comments about GSP following on after MFN status apply to OPIC, as well?

Ambassador HILLS. I am sorry?

Mr. PEASE. Do your comments about GSP following on after MFN approval apply to OPIC, as well? Will you be looking at OPIC, or is that within your jurisdiction?

Ambassador HILLS. Yes; that is a benefit that can be considered after MFN.

Mr. PEASE. I know it can be considered, but is it the administration's plan to try to provide not only MFN, but also GSP and OPIC coverage for the countries of Eastern Europe, where that is appropriate?

Ambassador HILLS. Yes.

Mr. PEASE. It is?

Ambassador HILLS. Yes.

Mr. PEASE. Lastly, since the chairman is not looking at me too hard, I have a particular interest in the concern you mentioned in your testimony about American-built, American name-plate automobiles, since a great number of them are made in my State of Ohio. Are you optimistic in our dealings with the European Community that there will be no restrictions on the export of American-made, Japanese name-plate automobiles into the Community?

Ambassador HILLS. We have made it clear that we would take grave offense, were their directive to be so constructed as to have an adverse impact upon Japanese name-plate autos built here. We have been assured by the Vice President of the Commission that is neither their intent nor their purpose and that that restriction will not occur.

Although I have been so assured, I tend to be vigilant as to how that directive does develop, because what they are trying to do is to create a transition period as they harmonize a very difficult rule where there are five States with quotas and seven without. It will be the first time that they have taken a restriction and raised it for some, rather than harmonize in a less restrictive way. That disappoints us, in and of itself, but we are very anxious that, if they do engage in negotiating a quota through a voluntary restraint measure, such quota not affect our American automobiles.

Mr. PEASE. Thank you. That is very reassuring, and I presume you would characterize your cautious approach as something like trust, but verify.

Thank you.

Mr. GIBBONS. Mrs. Johnson.

Mrs. JOHNSON. Thank you, Madam Ambassador, for your very comprehensive and interesting testimony.

I have just a couple of questions that I wanted to ask. Is the EC, in your estimation, supporting United States' objectives at the Uruguay round in the areas of intellectual copyright, government procurement, and dumping rules?

Ambassador HILLS. They are, I think, of the same view as are we in intellectual property and end results. We may part company a little bit on tactics. On dumping, I believe we stand in a similar stead. They are taking a strong position to protect their dumping laws. And your third area was?

Mrs. JOHNSON. Government procurement.

Ambassador HILLS. Yes; we are, of course, negotiating government procurement. We are having a bit more difficulty with the European Community in that area. Government procurement is governed by a code, as you know, and the EC has for years had an exclusion with respect to transportation, water, telecommunications and energy. We are trying to have those sectors, those so-called excluded sectors, opened and we are in a difficult negotiation as they develop their rules. I am hopeful that they will understand the benefits of opening up that procurement.

Mrs. JOHNSON. And is that true, both in terms of their directive process within the EC, the development of the directive governing government procurement and in terms of the dialog in Uruguay?

Ambassador HILLS. The troublesome part about the EC proposed directive is that they have used a local content component in their procurement directive. Thus, member States could disregard foreign bids that had less than 50-percent local content. And where the foreign bid has more than 50-percent local content, it would be required to be reviewed as a bid, there is a 3-percent price differential. These sorts of restrictions we would like to have eliminated in their directive.

In the Uruguay round, we are negotiating to broaden the coverage of the procurement code and to get more States to sign it. It is just a difficult, hard-headed negotiation. I think there are benefits for all from opening up procurement.

Mrs. JOHNSON. I do think that is an extremely important part of our negotiations with the EC and at Uruguay, because in many of those areas we are the top producer or we are amongst the top producers and those often represent new areas of competition, as opposed to the old established areas. So, I am very interested in following the progress of both your conversations with the EC in regard to the development of their directive governing government procurement and the Uruguay rounds in that arena.

Ambassador HILLS. We will be glad to stay in close touch with you.

Mrs. JOHNSON. Thank you.

One of the things that concerns me is increasing the tremendous opportunity for trade with Eastern Europe. On the other hand, as we increase trade with Eastern Europe, there is the possibility, because they are an economy that has not been based on our accounting principles and things like that, that we would not be able to get the information we need to enforce our dumping laws, should problems develop in that regard or that triggered those concerns. Has this been a part of your discussions at all? Are you satisfied that they are going to develop the kind of system that will provide us with the information we need to govern trade fairly?

Ambassador HILLS. We are trying to get a channel of information, yes, in our discussions and we have sent technical teams to help them develop the capacity to gather the data that now they just do not have.

Mrs. JOHNSON. I do appreciate that they do not gather that data now, as they do not gather the data with individual companies that they need even to do business with us or to develop joint ventures with us, but I do think it is very important.

The signals are consistent and precise from both the private sector and government in the western world, not just the United States but the European Common Market, that this technical aspect of development in their country is very important, not only to the opportunities of individual companies within those countries, but to the peaceful regulation of trade matters between our governments over the long run. So, I am pleased to see that you are focusing on those technical aspects to some extent with them.

My time has expired, but I would like to ask you, for the record, a couple of questions for my colleague Mr. Chandler from Washington, who had to leave. He would like to know what are your plans to assist United States tobacco exports to Eastern Europe, along the line of what the United States Trade Representative has done in Thailand? Second, are you willing to consider health concerns, when promoting the export of a product that is harmful or an addictive drug? So, if your staff would reply to the Congressman, he would appreciate it.

Ambassador HILLS. I would be pleased to do that.

Mrs. JOHNSON. Thank you.

Mr. GIBBONS. Thank you.

Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman.

Madam Ambassador, we are particularly appreciative of your coming today. I must say when I first learned of your appointment as our Trade Representative, I was intrigued with the description I heard of you, which was that you would be capable of performing brain surgery tomorrow morning, if you just had a few minutes to study about it this afternoon. As I have followed your performance in trade negotiations, I must say that I think that was an accurate description of your abilities and the effort that you have put into representing our country.

I have been particularly impressed with the wide variety of areas that I am not sure people would have expected you to be an expert on, particularly the European Economic Community's restrictions on U.S. beef, I thought displayed an extraordinary amount of research when the research scientists we talked to indicated that you knew more about it than they did. So, I think you have developed a very commendable record, an outstanding record for our country.

Ambassador HILLS. Thank you very much

Mr. BROWN. I would be interested in your views on the potential danger to our country, if indeed you think there is as potential danger, of the European 1992 development of the integration of the Common Market, in that it appears to develop much closer cooperation between the European Economic Community, while at the same time excluding the United States, to some extent. I guess the concern I have is that is there a potential that this will cause the United States and Europe to grow apart in the future.

Ambassador HILLS. I think not. I think that the march toward a single market that is now well under way in Europe is a phenomena that we in this country have supported. We, after all, gave them Marshall aid plan funds of roughly $90 billion in today's dollars to get back on the road to prosperity.

We applauded their signing the Treaty of Rome, which launched the European Economic Community. And we are very admiring of the deregulation that would remove barriers amongst the 12 of them and create a market of 320 million consumers, with $4 trillion in gross domestic product. Our entrepreneurs can enter at Portugal and sell north to the United Kingdom or all the way down to Greece and over to Spain and up to Germany, without any of the regulatory barriers that were met a decade ago. So, for all those reasons, we see it as a very good thing, as a commercial opportunity.

Mr. BROWN. You do not think it makes us less competitive in their market? You do not think it gives other European countries more of an advantage over us than they might have had without integration?

Ambassador HILLS. I think that, in the main, it makes that market more accessible to us than it was before. But having said all of that, we are vigilant, because they have their protectionist tendencies, just as have we, and we have to watch that, as they harmonize the rules among the 12 of them, they do not take the most protectionist course, but they take the most liberalized or the least protectionist course. In the main, with the directives that have caused us problems, they have tended to be accommodative to the interests that we have brought to their attention.

We were pleased with how they handled the banking directive, the merger and acquisition directive and the trucking directive. With each of those, we had serious problems. We were not pleased with how they handled their broadcast directive. So, they will make mistakes, in our view, from time to time, but that does not mean that we are antagonistic toward the single unified market.

Mr. BROWN. Thank you.

I also wanted to add my concern, one you have heard earlier today about the apparent dishonoring or failure to honor the El Al and Aeroflot agreement. I guess my concern centers around the potential that restrictions or impediments in letting refugees out of the Soviet Union could be a tragic development. If indeed the policies changed in the near term, and in listening to your remarks, I take it that you share that view and that you are committed to raising that with the Soviets in our negotiations.

Ambassador HILLS. I will tell you that the Secretary of State has raised that in his negotiations and that we certainly will pass that on to our counterparts.

Mr. BROWN. You are not going to let me put words in your mouth?

Ambassador HILLS. As I mentioned earlier, I think that we have fully described the conditions that the Soviets must fulfill for MFN. We are already well into the second round of negotiations, and we have said what they must do in order to get most-favored-nation status. They have already introduced their immigration laws and are in the second reading of their law. We would prefer not to interrupt that process to add further demands, but rather handle them on a political agenda.

Mr. **Brown**. One last question. We are now drawing to a close on the Super 301 procedures, at least in terms of identification of unfair trade practices. Would you share with us your view of how useful that has been, how valuable that has been and what kind of results you expect from that process, as it goes on to try and negotiate the ending of those practices?

Ambassador **Hills**. The statute is something of a good news/bad news story. The greatest leverage comes before designation. Our goal is not to retaliate, but, rather, to achieve a marketing opening. The greatest leverage we have is immediately before we designate. After designation, if we are negotiating, you can contemplate a plateau, well we are negotiating on the top or a plateau. After designation, it is quite difficult to bring the negotiation back to the same momentum in a short period of time. So designation creates something of a hiatus.

On the other hand, we are trying to open up markets that are not adequately covered by multilateral rules. It is a tool that we have used successfully. We have achieved some success in opening markets, and we will continue to try to enforce the law and achieve maximum success.

Mr. **Brown**. I take it that you feel the process particularly up until designation has yielded results?

Ambassador **Hills**. I am sorry?

Mr. **Brown**. I take it that you feel the process up until designation certainly has yielded results, then?

Ambassador **Hills**. I do think that we have achieved some market openings. Perhaps if we had a longer period of time before we had to designate a particular country, that would give greater flexibility to the statute.

Mr. **Brown**. Thank you.

I yield back, Mr. Chairman.

Mr. **Gibbons**. All right. Are there any other members of the committee who would like to ask questions now? Any others?

[No response.]

Mr. **Gibbons**. Thank you for coming today. I want to say that history has cast you in a very important position and I feel that you are personally qualified to handle it. I am not sure that America, though, the United States Government in particular, has geared up to the problem that we have.

So many things have transpired in the last year or so, the European Community has taken on an added rejuvenation and more challenge to you. The GATT round is extremely difficult, the most difficult round that we have ever undertaken, by far. Everything else has been child's play, compared to this round. Then the sudden rush for freedom in Eastern Europe and in Russia.

I feel that you can do it, but I am not sure our Government is up to the challenge right now. I am afraid that we have not put together the institutions that we need. That is no reflection upon you, and it is certainly no reflection upon the quality of the people that you have working for you, but it is something that deeply worries me.

I want to say on a personal note that you seem to be holding up well under all of this. We scheduled this as a hearing on Eastern Europe and Europe 1992 and we covered about everything under the sun, including South Africa. So, congratulations for a job well done.

Ambassador HILLS. Thank you, Mr. Chairman.

Mr. GIBBONS. You have a meeting this afternoon, I believe, with the President of the European Community. Good luck.

Ambassador HILLS. Thank you very much.

Mr. GIBBONS. Thank you.

The committee is adjourned.

[Whereupon, at 4:22 p.m., the committee was adjourned.]

[Mr. Chandler submitted two questions and extraneous material for the record. That material and Ambassador Hills' responses follows:]

Chandler

WAYS & MEANS FULL COMMITTEE HEARING
CARLA HILLS
FEBRUARY 28, 1990

1) WHAT ARE YOUR PLANS TO ASSIST US TOBACCO EXPORTS TO EASTERN EUROPE ALONG THE LINE OF WHAT THE USTR HAS DONE IN THAILAND?

2) ARE YOU WILLING TO CONSIDER HEALTH CONCERNS WHEN PROMOTING THE EXPORT OF A PRODUCT THAT IS A HARMFUL AND ADDICTIVE DRUG?

CHESTER G. ATKINS
5TH DISTRICT, MASSACHUSETTS

COMMITTEES
APPROPRIATIONS
STANDARDS OF OFFICIAL CONDUCT

AT LARGE DEMOCRATIC WHIP

LINDA J. HARTKE
ADMINISTRATIVE ASSISTANT

Congress of the United States
House of Representatives
Washington, DC 20515

REPLY TO:
☐ WASHINGTON OFFICE
504 Cannon Building
Washington DC 20515-2106
(202) 225-3411
☐ DISTRICT OFFICE
134 Middle Street, Suite 320
Lowell, MA 01852-1886
(508) 459-0101
Toll free (800) 831-2125

JUN 1989
RECEIVED

May 31, 1989

The Honorable Carla A. Hills
United States Trade Representative
600 17th Street, NW
Washington, DC 20506

Dear Ambassador Hills:

We are writing to express our most serious concern over your decision to pursue Section 301 actions against Thailand on behalf of the United States Cigarette Export Association. It is our belief that this action by the Office of the United States Trade Representative perpetrates an extraordinarily expensive and ultimately lethal health risk abroad. In addition, the U.S.C.E.A.'s contention that Thailand's ban on both domestic and foreign cigarette advertisements on television, radio, newspapers and magazines constitutes an unfair trade practice is an affront to common sense.

It is deeply disturbing that the United States Government, which banned cigarette advertisements on television, required warning labels on packages and declared through the Surgeon General that tobacco is an addictive drug, is aggressively promoting cigarette use in other countries through the trade office. It is even more troubling that the proposed 301 action will force the Thai government to overturn its long standing policy of restricting advertisements and promotion for all cigarette products regardless of its point of origin. This policy is in accordance with the Thai Government's desire to reduce cigarette consumption and cancer rates at home.

The latest 301 petition filed by the United States Cigarette Export Association against Thailand follows a similar pattern. The cigarette industry is most interested in introducing western-style marketing to dramatically increase demand for their product. Using vague and misleading language, the cigarette industry is pushing inexorably for television and radio advertising. We refer specifically to page 48, Section D, paragraph two of the U.S.C.E.A. petition which requests the right of cigarette companies to advertise in forms "permitted in other major Asian markets."

It is hypocritical for the United States to consider a television advertising ban abroad an unfair trade practice, but to consider a ban on television advertising at home a national health priority. In the case of Thailand, which does not allow cigarette advertisements for domestic brands on television and other media, the U.S.C.E.A.'s contention that this is an unfair trade practice is particularly egregious.

Ambassador Hills, we urge your office to reconsider the petition filed by the United States Cigarette Export Association against Thailand. The United States Cigarette Export Association, which grows, rolls and processes most of its tobacco overseas, has had great success through the Office of the United States Trade Representative. It is our belief that trade pressures should be exerted elsewhere, on behalf of industries that benefit U.S. manufacturers, farmers, entrepreneurs and importantly, the health and well-being of all the world's citizens.

We look forward to hearing from you shortly on this urgent matter. Thank you for your serious consideration of this request.

Sincerely,

Chet Atkins, MC

John Conyers Jr.
John Conyers, MC

James Scheuer, MC

Pete Stark
Pete Stark, MC

Ed Markey
Ed Markey, MC

Norman D Shumway
Norman Shumway, MC

Mike Synar
Mike Synar, MC

Claudine Schneider
Claudine Schneider, MC

Michael A. Andrews
Michael Andrews, MC

Mel Levine, MC

Rod Chandler, MC

Dick Durbin
Richard Durbin, MC

Lane Evans
Lane Evans, MC

Bruce A. Morrison
Bruce Morrison, MC

Barbara Boxer
Barbara Boxer, MC

James Hansen, MC

Ted Weiss
Ted Weiss, MC

Congress of the United States
House of Representatives
Washington, DC 20515

October 2, 1989

DON'T LET THE U.S. GOVERNMENT TAKE THE WORLD ON A TOUR OF MARLBORO COUNTRY!

Dear Colleague,

For the fourth time in four years, the United States Trade Representative is aggressively negotiating a petition submitted by the U. S. Cigarette Export Association alleging unfair trade practices against American cigarettes. After successfully negotiating advertising and market access in Taiwan, South Korea and Japan, the USTR and the multinational cigarette firms have set their sights on Thailand.

According to the cigarette industry's petition against Thailand "*advertising in print and outdoor media should be permitted. Point-of-sale material, . . . published brand sponsorship of events and functions, as well as sampling*" should be allowed. In addition, "*forms of advertising permitted in other major Asian markets should be allowed.*" After immense public pressure, the industry denied this to mean cigarette advertisements on television and radio.

Thailand, the fourth largest importer of American tobacco leaf in Asia, has national laws banning **all** forms of cigarette advertising for **all** cigarette brands domestic and foreign.

If you believe that the U.S. Government should not be expending valuable trade resources on behalf of market access and advertising rights for the cigarette industry, please cosponsor **HR 1249, the Tobacco Export Reform Act. HR 1249:**

1) Requires the Surgeon General's warning label on all exported cigarettes; and

2) Prohibits the U.S. Government from using its influence to coerce foreign countries into accepting U.S. cigarettes and cigarette advertisements.

Behind the smokescreen of market access and the ruse of encouraging brand switching, the cigarette industry has enlisted the USTR in its quest to aggressively promote nicotine addiction to new smokers throughout Asia. Once entry is gained into the new Asian markets, the cigarette industry markets heavily to women and children -- two groups who do not traditionally smoke. Slick promotional strategies that would be outlawed in this country have resulted in explosive growth in cigarette use in countries affected by USTR action.

At a time when Thailand is cooperating with U.S. efforts to eradicate lethal narcotics, it is wrong to push nicotine -- one of the world's most lethal drugs -- on their citizens. Don't let the USTR turn Thailand into Marlboro Country. If [illegible] HR 1249, please [illegible] call either Linda Kruegger at X5-6451 or Jim Kessler at X5-3411

Sincerely yours,

Mel Levine

Chet Atkins

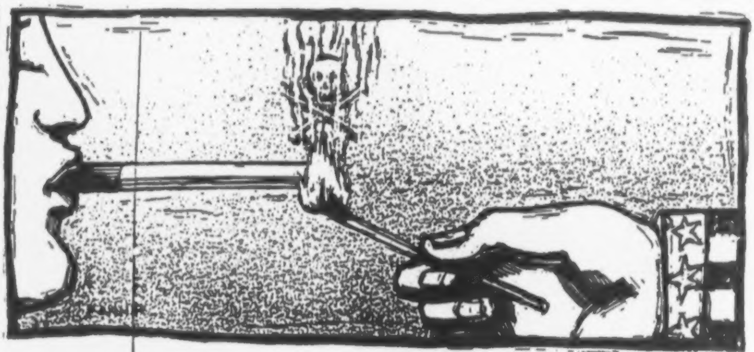
Bob Whittaker

Henry Waxman

Richard Durbin

James Hansen

LA TIMES 7/23/89



CATHERINE KANNER / for The Times

'Exporting Death': Cigarette Firms Attack Asia as Americans Smoke Less

By Charles Babington

WASHINGTON

A remarkable thing is happening in the U.S. cigarette industry: As America continues its 25-year decline in per capita smoking, total cigarette sales are booming.

The reason is that Asia suddenly, albeit reluctantly, dropped trade barriers to U.S. cigarettes. Pushed by Sen. Jesse Helms (R-N.C.), the Reagan and Bush administrations threatened costly sanctions against Asian countries that wouldn't allow the importation of billions of Merits and Marlboros.

U.S. cigarette exports rocketed to $2.6 billion last year, more than double the total three years ago. Sales have grown by more than 2,400% in Taiwan and South Korea since 1985. Japan, where nearly two-thirds of the men smoke, has replaced Belgium as the No. 1 importer.

An increasingly vocal group of public officials calls this a deal with the devil, contending that thousands of Asians will die from lung cancer and other smoking-related diseases after smoking the same products that the U.S. government has labeled hazardous. Some critics predict the aggressive U.S. export policy will one day reap worldwide resentment.

"I don't think that we as citizens can continue to tolerate exporting disease, disability and death," said outgoing Surgeon General C. Everett Koop.

This summer the U.S. effort to open Thailand's $744 million-a-year cigarette market reaches the touchiest issue of all, TV advertising. Like the United States, Thailand bans broadcast ads for cigarettes. But the U.S. trade representative recently launched an investigation of Thai import policies, spurred by a petition from major cigarette exporters that said, "In order to compete effectively in Thailand, the U.S. cigarette manufacturers need to advertise and promote their products."

Spokesmen for Philip Morris and R.J. Reynolds say Thailand banned TV ads only recently, figuring that its government-controlled cigarette monopoly could fend off U.S. imports by keeping their commercials off the air.

Yet the possibility of the U.S. government pressing for cigarette ads on foreign television infuriates Congress' anti-smoking forces.

"It is hypocritical of the United States to consider a television advertising ban abroad an unfair trade practice, but to consider a ban on television advertising at home a national health priority," said a letter to U.S. Trade Representative Carla A. Hills signed by 17 House members, including Californians Pete Stark (D-Oakland), Barbara Boxer (D-Greenbrae), Mel Levine (D-Santa Monica) and Norman D. Shumway (R-Stockton).

The group's leader, Massachusetts Democrat Chester G. Atkins, said recently: "Thanks in large part to actions by the U.S. government, a pandemic of lung cancer in Asia is not just likely, it is inevitable."

Government and tobacco leaders dismiss those arguments as naive, saying the critics are being unfair. They contend they merely want U.S. cigarettes to be treated the same as Asian-made cigarettes in the lucrative Far East market.

"Whether American cigarettes are purchased abroad is, and should be, up to the consumer," said Donald S. Harris, a spokesman for Philip Morris International. "The role of the United States trade representative is to ensure that our products get fair treatment."

Clayton K. Yeutter, the U.S. trade representative who led the fight during the Reagan years, is President Bush's secretary of agriculture. "If countries want to put in place regulations that in some way affect consumption of tobacco products, it's their sovereign right to do so," Yeutter said. "But they cannot be discriminatory about it."

The big U.S. assault on the Asian cigarette market began in July, 1986, when Helms, representing the nation's No. 1 tobacco-producing state, wrote a tough-worded letter to Japanese Prime Minister Yasuhiro Nakasone. Helms then was chairman of the Senate Agriculture Committee and was the second-ranking Republican on the Foreign Relations Committee. Those two positions, plus long-standing ties to Reagan, gave him a clout the Japanese could not ignore.

Japan is a big cigarette producer and consumer, its monopolistic tobacco industry controlled by government. In 1986, high Japanese tariffs and other trade restrictions resulted in less than a 4% market share for U.S. cigarettes, even though their quality is highly regarded.

Helms' letter was a thinly veiled threat that fellow senators were losing patience. He warned the prime minister that "very damaging decisions" regarding U.S.-Japanese relations might result. "May I suggest a goal of 20%" of the Japanese cigarette market for American producers within 18 months, he wrote.

Nakasone didn't move quickly enough; two months later, Helms and 12 other senators from tobacco-growing states wrote to President Reagan, advocating retaliation. Reagan told Yeutter's office to begin sanctions that would include bans on various Japanese exports. Japan quickly lowered the cigarette barriers.

One year later, then-Ambassador to Japan Mike Mansfield wasn't exaggerating when he wrote to Helms that the results "were spectacular."

By 1988, American cigarettes were grossing $606 million in Japan, more than six times the amount for 1985. The cigarette industry was ecstatic. It knew whom to thank.

"You have indeed accomplished a once-in-a-lifetime success for the U.S. tobacco business," Ernest Pepples, senior vice president of Brown & Williamson Tobacco Corp., wrote to Helms in October, 1987. "You got us in Japan."

Then Helms turned to South Korea, using the same tactics: letters followed by the initiation of trade sanctions. The Koreans gave in. Imports of U.S. cigarettes increased ninefold last year and South Korea agreed to allow aggressive print advertising—much of it aimed at women and young adults, an audience virtually ignored by the national cigarette monopoly.

The same scenario played in Taiwan, with widespread advertisements lacking the health warning notices required in U.S. publications.

Atkins, furious, said the message is that "Asian lungs are more expendable than American lungs." Cigarette makers, meanwhile, aren't ignoring Asia's biggest market, China, where 90% of adult males smoke and 1.4 trillion cigarettes are consumed yearly.

The international arm of R.J. Reynolds has opened a cigarette plant in Xiamen as a joint venture with a Chinese firm. The plant soon will produce 2.5 billion cigarettes a year, including Camels, Winstons and two Chinese brands, said Brenda H. Follmer, a spokeswoman for R.J. Reynolds Tobacco International Inc.

If current smoking trends continue in China, British health authority Richard Peto has said, 50 million of the half-billion Chinese now under age 20 eventually will die of smoking-related diseases.

Follmer, the Reynolds spokeswoman, said press reports overlook Asia's high smoking rate, which existed long before significant U.S. exports were allowed and was often encouraged by government-controlled monopolies. "The media never seem to want to follow through on the fact that these people have been manufacturing and smoking cigarettes for a long, long time," she said. "And if we stopped producing or exporting a single cigarette to those markets, they're going to keep on smoking, and we're not going to have any bearing on that."

Rep. Atkins disagreed: "We used to be the No. 1 exporter of good health; now we're the No. 1 exporter of death." ☐

Charles Babington is the Washington correspondent for the Newsend Observer and the Raleigh (N.C.) Times.

QUESTIONS SUBMITTED BY CONGRESSMAN CHANDLER

Q1: What are your plans to assist U.S. tobacco exports to Eastern Europe along the lines of what the USTR has done in Thailand?

A: The Office of the United States Trade Representative is not charged with promoting exports of American products -- that is the role of the Commerce Department. The USTR conducts and coordinates trade negotiations -- for instance, when foreign governments have erected barriers to our goods and services. If East European governments (or any other for that matter) engage in practices which discriminate against American products, or which create unfair barriers to trade, we will challenge these practices in all appropriate fora.

Q.2: Are you willing to consider health concerns when promoting the export of a product that is a harmful and addictive drug?

A: Again, the United States Trade Representative does not promote products. However, we would defend any American product against discriminatory or unfair government measures abroad. The United States fully recognizes the right of each country to impose restrictions on the sale and use of any product to meet legitimate health policy goals. It is not appropriate, however, to restrict only U.S. or other foreign products while permitting consumption of the same local products. It is my obligation under U.S. trade laws and our right under GATT to ensure American businesses can compete on an equal basis with local and other foreign producers.

U.S. TRADE RELATIONSHIPS WITH THE SOVIET UNION AND EASTERN EUROPE, THE IMPLICATIONS OF "EUROPE 1992" ON AMERICAN DIRECT INVESTMENT, AND FOREIGN INVESTMENT IN THE UNITED STATES

THURSDAY, MARCH 1, 1990

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met, pursuant to notice, at 10:06 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. The committee will come to order.

Today we continue our hearings on United States trade with the Soviet Union and Eastern Europe, the implications of "Europe 1992" on United States direct investment, and foreign investment in the United States.

Our witness today is Hon. Robert Mosbacher, Secretary of Commerce. He has been actively involved in United States trade relations with the Soviet Union through his position as Cochairman of the Joint United States-U.S.S.R. Commercial Commission.

He also has led a delegation of United States business representatives to Poland and Hungary, and is participating in negotiations on business and economic agreements with those countries.

Finally, Secretary Mosbacher has had many discussions with his counterparts in the European Community on the EC's progress toward a single market. This experience gives him a good perspective on the issues before us today.

Secretary Mosbacher, we welcome you before the committee and look forward to your testimony.

If there are no other members that would wish to make any observations, Mr. Secretary, it is all yours.

STATEMENT OF HON. ROBERT A. MOSBACHER, SECRETARY, U.S. DEPARTMENT OF COMMERCE

Secretary Mosbacher. Thank you, Mr. Chairman. It is a pleasure to be here with you. And if I may, I will have my prepared statement included in the record if that——

Chairman Rostenkowski. Without objection, your entire statement, Mr. Secretary, will be included in the record. You may summarize if you care to.

Secretary **Mosbacher**. Thank you. Then I would now go into just an outline of what I think is important that has been going on in our European and East-West trade area.

Never really have we in this country, the United States and the free world, confronted this kind of challenge, a tremendous opportunity to shape the economic future of the EC and Eastern Europe.

We find that the opportunity involves questions that have long remained dormant. Political questions that were never fully resolved in the postwar period are now joined with the economic challenge of EC 1992, and the transformation of Eastern Europe into a market-based economic system.

In opening, I would like to summarize the activities of the Commerce Department and the administration in meeting the challenges.

Our fundamental policy objective is to create a climate for United States private sector participation in the benefits of EC 1992, and provide the private sector with the ability to make critical capital investments in Eastern Europe and the Soviet Union.

In recent months, I have made several trips to Europe to address the concerns for American businesses in the implementation of EC 1992 and the opportunities that have emerged behind the disintegrating Iron Curtain.

After calling for greater access to the EC 1992 process, we reached an agreement with EC Vice President Bangemann, which offers a steady flow of information in dialog on standards, the No. 1 concern of American business. Under the agreement, American industry can comment directly on problems that develop in the EC-wide standards-setting process now underway.

We are establishing the same procedure for the testing and certification regime that will be implemented by the EC.

Our dialog with EC officials on standards, testing, and certification will be supplemented by guidance from American business executives serving on a newly formed advisory committee to the Commerce Department focusing on these and other EC 1992 issues.

In addition, the Commerce Department will open a Foreign Commercial Council Service Office to the EC in Brussels.

In September, I led a group of business executives to Hungary and Poland as a followup to the President's July visit. I went to Poland again in November as a member of the President's economic mission, and have just returned from Czechoslovakia.

Since September, the U.S. Government has taken steps to help our private sector meet the challenges of the region. While in Hungary and Poland, we started the negotiations of comprehensive business and economic agreements to provide a framework for American private sector activities in both countries. We signed tourism agreements with each government, and arranged to begin a series of legal and accounting seminars to help develop skills necessary to support a market economy.

A highlight of our September trip and the November Presidential mission was the participation of high-level American business leaders. From the assessment of both Government and private sector mission participants, priorities such as telecommunications, banking, and distribution systems, have been identified.

We followed up these trips with an increased emphasis on trade missions, such as the Budapest International Fair and the Poznan International Fair. In fact, very successful telecommunications trade missions to both Poland and Hungary were just recently completed. Missions focusing on electric power, food processing, and coal are planned in the near future.

U.S. companies have initiated major investments. General Electric and General Motors have made investments totaling more than $300 million in Hungary. In Poland, there have been over 45 joint ventures so far with United States companies.

Commerce helped to organize the first branch of the American Chamber of Commerce in Hungary in November 1989. OPIC led an initial investment mission to Poland and has a second one planned in April.

Hungary was granted most-favored-nation status in October 1989, and the GSP, the generalized system of preferences, went into effect in November 1989.

The trade development program is also active on projects in both Hungary and Poland. The support for the East European Democracy Act, known as SEED, passed by Congress in November 1989, has offered direct support to market-oriented reforms.

The International Executive Service Corps will offer private sector technical and managerial assistance to Polish and Hungarian firms. The East European Business Information Center, initiated by the Commerce Department in January 1990, serves as a prime information source for U.S. business, answering 200 calls a day on trade and investment opportunities.

Having just returned from Prague, I know that the Czechoslovak Government is moving quickly toward establishing a market-oriented economy.

Along with the 20 United States business executives that joined us there, we had roundtable discussions with the Czechoslovak officials about commercial opportunities. U.S. negotiators will begin negotiations next week on trade and investment agreements which will serve to implement a waiver of Jackson-Vanik provisions and the extension of the MFN treatment.

An extension of the SEED legislation to Czechoslovakia will serve as a basis for OPIC and Exim programs. And if the President decides, also GSP benefits.

In recent weeks, negotiations were started on a trade agreement with the Soviet Union which will create a legal framework for United States firms and allow MFN to be offered to the Soviet exports at the proper time. Negotiations will be concluded prior to the June summit meeting.

In November, we held a promising meeting of the U.S.-U.S.S.R. Joint Commercial Commission to discuss trade and investment opportunities. It must, however, be recognized that existing market oriented reforms are moving slowly in the U.S.S.R. making most of our commercial opportunities very long-term prospects for United States firms.

Export controls and dealings in the COCOM are undergoing continuing discussions and rapid change is in the wind. We will be working closely both interagency and with our COCOM allies to bring these exports controls to a realistic level and completely up to date.

I want this to just be a summary. So I will end my comments here by simply saying that, in my view, we have an opportunity to advance the cause of freedom and free enterprise in the coming months in a way that's unparalleled in the past 40 years. It's a challenge that we not only can but we must meet.

Thank you, Mr. Chairman.

[The statement of Secretary Mosbacher follows:]

STATEMENT OF

HONORABLE ROBERT MOSBACHER

SECRETARY OF COMMERCE

BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS
MARCH 1, 1990

Mr. Chairman and members of the Committee:

I am pleased to be with you today to discuss the sweeping changes that are transforming the European economies -- both East and West. I want to commend you, Mr. Chairman, for holding these hearings, for what is happening in Europe will have the most far-reaching effects on our political and economic relations worldwide.

West Europe, East Europe, and the Soviet Union together account for close to 60 percent of the entire world GNP outside of the United States. What happens to Europe, and what Europe does, will affect American economic interests in vital ways.

In March of 1946, Winston Churchill lamented that an "Iron Curtain" was dividing Europe, and over the past four decades the concept of that iron curtain and the reality of the Berlin Wall have been among the most terrible symbols of a divided Europe.

Now, the Berlin Wall has been breached and is coming down. And across Europe, the Iron Curtain is being dismantled. Eastern Europe is preparing to reunite with the Western world and to begin constructing democratic systems and market economies. This is truly a revolution.

In Western Europe, another revolution is underway -- the movement to complete by 1992 a single market in the European Community of 12 nations and 320 million people. The new single market poses economic challenges and opportunities for the United States, and also serves as a magnet for Eastern Europe as it contemplates the relationships it must form for its economic and political future.

There are many uncertainties, Mr. Chairman, but I believe one thing is certain: Europe will play a larger economic and political role in the world, and our relationships with Europe must change to account for this. We must now consider the implications of a larger, more cohesive Europe, complete with a unified Germany and rediscovered partners in Poland, Hungary, Czechoslovakia, and elsewhere.

We must be prepared to seek a new architecture to address the changing realities of an integrated Europe. Secretary Baker proposed in Berlin only three months ago that the United States and the European Community must find new ways to institutionalize consultations with one another. I agree completely, and believe that from a commercial perspective we must be prepared to look even further.

Eastern Europe

For the past 40 years, Mr. Chairman, the countries of Eastern Europe isolated themselves from world market forces. They built a virtually impenetrable protectionist wall around themselves. They substituted non-convertible currencies and rigid central planning for the discipline of the market.

The result was a system of economic scarcity that couldn't produce adequate quantities of goods and services -- even at a level of quality so low that they couldn't be sold in the rest of the world -- a system that destroyed initiative and creativity, a system that uses production facilities that would have been scrapped in the West 20 years ago.

What we have seen is a vivid demonstration that Marxist economics does not work. The Eastern European countries are left with devastated environments, outdated technologies, inefficient and uncompetitive industries, and cost and price structures which have grossly misallocated their economic and human resources.

What this means is that though the "Iron Curtain" is being removed, an economic "Grand Canyon" still separates the Western economies from the newly emerging democracies of Eastern Europe. Bridging this chasm is one of the great challenges facing us all. It will require nothing less than recreating an entire set of public and private institutions that will allow private enterprise to function in Eastern Europe.

But there is no alternative. Half-way measures will not work. There is no magic wand. The stagnating and obsolete economies of the Eastern countries cannot be reconstituted merely by providing Western capital and know-how. They cannot function without creating or recreating banking systems, accounting systems, distribution systems, and all the other ingredients necessary to a marketplace.

One after another, the new regimes of the Eastern European countries are jettisoning state monopoly of ownership and central planning in favor of market forces and private initiative. Some countries at present are more committed to such a course than others; some are further ahead in creating the appropriate laws and institutions than others.

The course will not be easy, and they know it. The cost of economic restructuring -- of moving labor out of subsidized inefficient factories and into new, market-determined, areas is staggering. But despite the difficulties they face, I am hopeful. I just returned from Czechoslovakia, and in recent months I have been to Hungary and Poland. I have seen first hand the enormity of the task being faced.

But I have also seen the intentions and the determination of the people and the leaders of these countries. They are unwilling to give up their emerging liberty and to return to the systems of repression from which they are escaping. They know they have no choice but to endure the costs -- and I believe they will succeed.

We must do all we can to help them succeed. The West, and particularly the United States, has a vital interest and, I believe, a vital role to play as these countries embark on their historic changes. That effort is well underway, with the President's bold proposals and programs to assist not just Poland and Hungary, but all of Eastern Europe as it turns to democracy. We are working closely with our partners in the "group of 24", chaired by the European Community.

Part of our effort must be to provide realistic financial relief, and we are doing so -- as the Committee is hearing today from other Administration witnesses. But particularly after my recent visits to Eastern Europe, I am convinced more than ever that what is needed is private trade and investment and a solid participation by American business. This is the key.

The American entrepreneurial spirit, management and organization skills, and manufacturing and technological creativity are vitally important to the long-term success of political, economic and social reform in Eastern Europe. Trade and investment are the mechanisms by which the magic of the market can be transferred to Eastern Europe.

But this commerce and investment will not flow until the groundwork is created in the Eastern European economies that will provide the necessary assurances, comfort level, and ability for private enterprise to function in a true market environment.

Creating this environment is the first priority, and this is where the Commerce Department has been concentrating its efforts.

Our first priority has been to help develop an attractive and open market-oriented trade and investment infrastructure in the Eastern

European countries, starting with trade and investment agreements that will provide the necessary framework for American business.

My first goal in visiting Poland and Hungary last fall was to obtain their agreement to enter into comprehensive business and economic agreements with the United States. These bilateral accords will do more than anything else to create a climate in which American business is able to make a strong economic contribution.

The agreements will cover investment protection provisions, such as repatriation of profits, guarantees against expropriation, arbitration clauses, and the like. But they will also address the business facilitation infrastructure that is needed -- such as the ability to advertise and to select distributors.

We are working together with USTR, the State Department and other agencies in these negotiations, and are making rapid progress. I anticipate that by the time Polish Trade Minister and I meet later this spring to hold the next session of the joint Polish-American Trade Commission, an agreement excellent for both countries will be ready to sign. I anticipate that similar agreements with Hungary and with Czechoslovakia will not be far behind.

These commercial agreements are the prerequisite, but the more difficult task lies in actually generating business once the framework has been set. This is where I am directing the activities of the Commerce Department now.

We have to transcend the trade and investment foundation agreements, and create the actual opportunities for prospective business partners to meet each other face to face. Let me put the size of the task in perspective. Last year American exports to Eastern Europe were only $1 billion. This is barely larger than our exports to Finland alone. Moreover, all East European imports from the entire Western industrial world were only $21 billion in 1988 -- an amount less than Norway imported.

A tremendous job lies ahead to try to build a commercial relationship that will allow the Eastern European countries to enjoy the gains from trade. We have begun to build a role for U.S. business, but we need to do much more. We have started by focusing on where American industry can provide vital assistance to the Eastern European countries quickly. During my last visit to Poland, for example, I signed a telecommunications communique, which will lead to cooperative possibilities in this critical sector. We followed that up last month with a telecommunications trade mission -- which, incidentally, was oversubscribed by U.S. industry. We had to turn companies away.

We also are generating direct contacts between American and East European potential partners in a number of additional areas. We are promoting, for example, the use of the International Executive Service Corps, which places talented, experienced American retired executives in East European firms to help them learn how to function in the global economy.

One of our primary concerns in the Government-wide effort on Eastern Europe is private sector outreach. An important element here is the business information center called for in the Support for East European Democracies Act. The Department of Commerce began operating this center, the "Eastern Europe Business Information Center" (EEBIC), in January. It is the U.S. Government's central clearinghouse and information center for market information on East European countries, and so far it has handled over 4,000 requests for information from American business and private and volunteer organizations.

We will shortly be opening branch offices of our information center in Warsaw and Budapest, and then in other Eastern European commercial centers. This center is a major step in helping American and Eastern European enterprises learn how to do business with each other.

Additionally, the Department of Commerce is undertaking a major increase in trade promotion and business assistance in Eastern Europe, including bringing more commercial officers into these countries. We are going to have a sharp increase in the number of trade missions and other tools to create business.

To develop other business, I have directed the trade development part of the Commerce Department to undertake a major new innovative program to increase the use of export trading companies and export management companies. This has to be two-way business, for the Eastern European countries have to be able to sell if they are to buy.

As the lead agency responsible for implementing export control policy, we also recognize the need to reform controls in order to promote trade with Eastern European countries without compromising our national security. We have proposed to our COCOM partners a means to liberalize the International Control List in three areas vital to the industrial modernization of Eastern European economies: telecommunications, machine tools and computers. Further streamlining initiatives are under consideration in other product sectors that are subject to export controls.

The incipient private sectors in Eastern Europe pose many opportunities for small American companies as partners, and I believe that there is a major role for export trading and management companies to serve as sourcing and supplying agents to create business here. West Europeans have the advantage of being located next to the East European markets; and American companies -- particularly smaller ones -- need these specialized trading companies to enable them to compete for the new business opportunities in Eastern Europe.

USSR

Let me now turn to our trade relations with the Soviet Union. Major changes have been occurring in the Soviet Union and in the U.S. relationship with the USSR. This has been so in arms control, regional issues, emigration, and human rights.

In view of the changing overall relationship, at Malta the President initiated a new era in our trade and commercial relations with the Soviet Union when he proposed negotiation of a trade agreement and an investment agreement, support for Soviet observer status in the GATT after completion of the Uruguay Round, and other steps which would increase trade.

The Commerce Department is working closely with USTR, the State Department, and other agencies to ensure the historic U.S. Trade Agreement with the Soviet Union is balanced and serves U.S. economic interests.

It is important to recognize that, contrary to some of the Eastern European countries, the USSR, with some minor exceptions, has not yet begun to create a market economy. The Soviet Union appears to be seeking a middle road between a centrally planned and administered system and a decentralized system responding to market forces. Soviet ministries and enterprises are receiving and sending confused signals. In foreign trade, in particular, the situation is very uncertain.

In this environment, the short run opportunities for U.S. companies lie primarily in increasing their share of what is a limited market. While the Soviet Union is one of the world's largest economies, its hard currency export earnings are only about $30 billion annually -- about the size of Denmark's.

It is also important to bear in mind that the Soviet Union is likely to maintain central direction over the allocation of import licenses and hard currency availability for some time to come. Thus, while granting Most-Favored-Nation tariff treatment to Soviet exports to the United States would result in meaningful tariff reductions and an increase in Soviet sales to the United States, the reverse is not necessarily true. Soviet tariffs would not necessarily be meaningful, and MFN tariff treatment in the USSR will probably not in itself generate any significant additional U.S. exports.

Thus, I believe it is imperative that our trade agreement with the Soviet Union contain offsetting benefits for the United States that will actually make it possible for American firms to sell more in the USSR. I have in mind such things as the abolition of onerous registration requirements that constrain the ability of American companies to do business in the Soviet Union. It is clear to me that business facilitation provisions, such as assuring U.S. companies they can deal directly with private cooperatives and end-users, and that they are free to select their agents and distributors, are the key to an agreement that truly contains a "balance of concessions".

Democratization in the Soviet Union and the encouragement of increased realization that only a market economy based on private ownership can create a better economic future for the people of the Soviet Union are important goals. We support perestroika and the human rights and political reforms that have been made by President Gorbachev. But we hope for more.

I believe increased and broadened commercial contact with the West, and especially with the United States, is extremely important in this regard. As a further step, I intend to devote greater resources toward building a larger commercial relationship with the Soviet Union. While our national security needs must remain paramount, I firmly believe that it is in our national interest to help U.S. companies build long-term business with the Soviet Union in nonstrategic goods and services.

Right now, Mr. Chairman, our exports to the USSR are $4 billion a year -- mostly grain. While this is a significant amount, Mr. Chairman, I believe that with a lot of careful work, it should be possible to increase our trade many times over. The mere signing of a trade agreement won't do this. The trade agreement will allow commerce to begin to grow, but it won't happen on its own. The key factor limiting trade now is that the USSR doesn't have enough to sell.

But with a determined effort on the part of American industry, and with a recognition that for the Soviet Union to buy a lot more from us it has to sell a lot more to us, I believe we can make major gains in the growth of business that will benefit both countries, and that will make the strongest contribution to an increased Soviet recognition that their economic future lies in a private sector market economy.

I want to emphasize again, Mr. Chairman, that I am talking about peaceful, nonstrategic trade; but I believe there are huge opportunities for such trade in agriculture, food processing, medical and health care products, the production of consumer goods, and other similar areas. The Soviet Union has enormous unmet demands, and only the United States has the know-how and the ability to build an efficient ocean-to-ocean, continental scale system of production and distribution that the Soviet Union needs.

EC 1992

Mr. Chairman, let me now turn to Western Europe, for dramatic and rapid changes are occurring there as well. The European Community (EC) is well on the way to creating one single market out of the 12 member countries, completing what it started in 1958. The EC is fulfilling the hopes of its founders, and of America. We have always supported the concept and the growth of the European Community to bind the European nations together peacefully and to create a strong economic partner for the United States.

The EC is our largest trading partner today. Last year we exported $87 billion to the Community, and American companies operating within the EC produced and sold an additional $500 billion. I want to point out, Mr. Chairman, that last year we had a $1.5 billion surplus in our trade with the EC. That contrasts sharply with the $21 billion deficit we had with the EC just two years earlier.

The gain came from a $26 billion increase in our exports to the EC and only a $4 billion increase in imports from the EC. This demonstrates two very important points: first, the EC is an open market to American exporters. As the EC's 1992 program is being implemented, we are seeing markets for American products increasing -- not contracting. And second, our trade with the EC shows that U.S. industry can and does compete very well when it faces a relatively level playing field.

I have to compare our sharp trade gains in the EC, Mr. Chairman, with our trade with Japan, where our $52 billion deficit in trade the year before last was still a $49 billion deficit last year. The contrast is startling.

The past 12 months have been productive ones for U.S. commercial relations with the EC. The return of a surplus in our trade is, of course, most welcome. But additionally, over the past year we developed a full dialogue with the EC, we are consulting regularly on copyrights, drug registrations, and standards, to name just a few. We have seen some major progress in problems in standards and other areas, and we have increased our cooperative efforts in such areas as working together to assist Eastern Europe.

Here again reform of national security export controls is also important. In consultation with our COCOM allies, the United States plans to lift most export licensing requirements to the EC countries that are COCOM members as well as non-COCOM members. We expect to take this action within the next several months. By acting well before 1992, we should help United States high technology companies gain a better footing in the EC market without compromising multilateral security.

For the most part, the EC markets have been open to all forms of U.S. investment. Our investment position in manufacturing and distribution in the EC has been substantial and growing. Generally, U.S. business experience has been that investment in Europe has been undertaken for primarily commercial reasons and in response to market forces.

However, there are areas which continue to concern U.S. business executives, where EC actions appear to go against the Community's stated policy of openness and support for equal access. For example, the U.S. Government and U.S. companies have indications that certain EC rules of origin, applied in conjunction with the EC's antidumping and anticircumvention legislation, in effect act to compel EC content in certain manufactured products. This is a matter of considerable concern to us, and we are working on it bilaterally and multilaterally.

We have other concerns as well, particularly in the use of local content requirements such as in the EC's broadcast directive. And we are concerned about possible EC actions to limit auto imports from Japan -- actions that could affect U.S. exports.

I do not want to minimize the problems which we have with the EC, Mr. Chairman. But based on the progress we have made over the past years on the issues of greatest concern to us -- such as standards and national treatment instead of reciprocity -- I am confident that European officials share our desire for open markets and fair treatment, and that we will be able to solve our problems.

I am particularly confident because of the cooperative approach the EC has taken with us in the critical area of standards and testing and certification. U.S. business and U.S. standards experts feel more comfortable that, as EC Vice President Bangemann and I agreed last year, the EC and European Standards Organization have established policies to increase access for non-EC entities to the standards process. We will continue to monitor the progress made in the practical implementation of these policies.

Naturally, as is the case with many issues, there is always room for improvement. We are now working with the EC to obtain mutual recognition of testing and certification procedures -- which would particularly benefit smaller American and European companies.

However, my point today is that the pragmatic cooperative approach we took in the standards area sets an excellent precedent for broadening and enriching the overall U.S.-EC relationship, serving as a way of taking us closer to the goal that Secretary Baker outlined in December.

In his remarks before the Columbia Institute Conference on 1992, EC Commissioner Frans Andriessen held out the possibility of some form of association with the European Community for the new East European democracies. This is yet another clear sign of evolving economic and commercial ties within Europe, ties that could eventually lead to a commercial confederation that would include the EC and EFTA countries, as well as the emerging democracies of Eastern Europe and perhaps even the Soviet Union.

Mr. Chairman, given the importance of the EC as a market for United States firms, and the tremendous potential of markets in Eastern Europe and the Soviet Union, we must ask ourselves where the U.S. envisions itself as the future of Europe unfolds. While we support the further development of economic integration on the European continent, it must not be at the expense of trade barriers constructed around the periphery of a newly united Europe.

Foreign Direct Investment in the United States

Finally, Mr. Chairman, I would like to briefly discuss the last topic you have asked me to testify on today -- foreign direct investment in the United States.

With respect to foreign direct investment, the Administration is convinced that, except in a limited number of cases in which it can be shown to be harmful to the national security, foreigners should be allowed to acquire U.S. production facilities, just as Americans should be allowed to acquire foreign production facilities. We strongly support international trade and investment based on market forces as an important contributor to keeping our economy strong.

Among the benefits of foreign direct investment in the United States are the following:

- increased competition in the U.S. marketplace.
- transfer to the U.S. economy of technology, marketing, and product advantages enjoyed by foreign firms.
- lowest possible prices to U.S. consumers since both foreign and domestic firms will be free to serve the U.S. consumer as cheaply and efficiently as they can.

We are aware that many Americans are concerned about the growth in the 1980s in foreign ownership of U.S. assets, both through direct investment and portfolio investment. In part, this concern is warranted, since the growth in net foreign investment in the United States reflected the growing inadequacy of our domestic saving to finance our investment needs. However, the answer to this inadequacy is not restrictions on foreign investment in this country. Rather, the only effective answer is to raise our domestic saving so that we can reduce our dependence on foreign sources of capital.

In his State of the Union Address, President Bush placed strong emphasis on the need to raise the U.S. saving rate and proposed a course of action to accomplish this goal. Most important in this connection are the steps that the President has outlined to reduce the Federal budget deficit. Until we bring the Federal budget deficit down substantially, our domestic saving will likely remain below our investment needs, so net foreign investment in the United States will have to remain high.

Irrespective of the size of the gap between our domestic saving and investment, foreign direct investment in the United States will likely remain substantial in coming years. Foreign company production activity in the United States is still not overly large, given the technological and marketing strides that foreign companies have made since World War II.

Nevertheless, just as the rate of expansion of U.S. foreign direct investment abroad has slowed in recent decades, it is reasonable to expect that the rate of expansion of foreign direct investment in the United States also will decline in coming decades as foreign firm production in this country begins more closely to reflect the international competitive strength of the various major foreign firms. In the case of the Japanese firms, direct investment in the United States has only recently become significant in volume. It is clearly in our best interests that the strong Japanese automakers and electronics manufacturers are beginning to supply a growing portion of their U.S. market with products made in this country rather than in Japan.

While the Administration generally opposes restrictions on foreign direct investment, we are aware that in certain circumstances foreign takeovers of U.S. firms may be harmful to the national security. Thus, we will continue to enforce vigorously Exon-Florio provisions of the Omnibus Trade and Competitiveness Act of 1988. At the same time, we intend to insure that these provisions do not become a burden that would generally discourage foreign direct investment to the detriment of our consumers and industries.

Finally, but of particular importance to the Department of Commerce, the Administration is taking steps to improve the information available on foreign direct investment. Specifically, the President's 1991 Budget calls for a program to develop market-value data on foreign direct investment. At present, our data on foreign direct investment are on a book-value basis. Because U.S. direct investment abroad on average was made earlier than the bulk of the foreign direct investment in this country, the book-value data probably give a distorted impression of the relative size of foreign direct investment here and abroad.

Thank you Mr. Chairman. I will now be glad to answer any questions the Committee may have.

Chairman **Rostenkowski**. Thank you, Mr. Secretary.

Mr. Secretary, I'm concerned that the United States may not be doing all it could to help the countries of Eastern Europe develop the skills and know-how they need to succeed in their efforts to develop market-based economies in a free political environment.

You note in your testimony that the Department of Commerce is taking a number of steps to increase contacts between United States and Eastern European businesses and individuals.

Can you tell the committee whether actual contracts or other concrete results have been realized from these efforts? Is there more that you feel the U.S. Government and U.S. businessmen could be doing?

Secretary **Mosbacher**. Mr. Chairman, we are beginning to see results. In Poland, we've got 45 joint ventures or companies going in there that have already made commitments and started there. In Hungary, we have fewer in number but large amounts. You see, GE in the Tungtran deal spending $150 million. We see GM in the first stages of going into the automobile manufacturing.

In Czechoslovakia, it's really an incipient stage. But when we were over there, we were talking with GE again, and they are working on airplane engines and power station investments. We see Dow Chemical already in there but expanding.

So I think we can always do more and should do more, and must do more. But I think that it's the private sector that is going to have to do most of it.

The enterprise fund that you passed last fall is just getting underway. The members are going to be announced shortly. I think this will be helpful in both Poland and Hungary, and I hope there will be an addition for Czechoslovakia. This committee will be made up of both Americans and nationals of those countries to help set up joint private sector businesses that will get the private sector kicked off even better.

Chairman **Rostenkowski**. Well, Mr. Secretary, I am concerned with whether or not, because markets are so much more available here, and there is not the complication of exchange here, I am just wondering whether the American businessman has the appetite to get in there and struggle as hard as we need to.

There's no question in my mind, having visited the Eastern European countries, that they would love to trade with us. As a matter of fact, they think they prefer to trade with us than any of their neighbors or bordering neighbors as well.

I just wonder whether we can do anything to incite American business to get over there and really reach out for our part of the pie.

Is there anything that you can suggest? As a matter of fact, I was speaking to about 60 retired former chief executive officers the other day. And I suggested to them that maybe September and October are pretty good months for people to visit Europe. Maybe those senior citizens that have already retired that know a lot about marketing businesses could get over there and lend their helping hand. And it was amazing how much they thought it was a pretty good idea.

I think that it could be a freedom corps going over there and helping those people create and understand what the private sector in this country is all about.

I just wonder whether the Commerce Department is thinking about attracting people like that?

Secretary **Mosbacher**. Yes, we have, Mr. Chairman, and appreciate your thoughts on this, because we are trying to do what we can, and obviously we need to expand it even more.

We are reopening in Czechoslovakia a Foreign Commercial Service Office. We have been expanding our offices in both Hungary and Poland.

On the U.S. business side, we have been instructing the district and regional offices of the U.S. Foreign Commercial Service to notify people about the opportunities and trying to do more matchmaking in these areas. And the IESC, with whom we have been working, which is the International Executive Service Corps, made up primarily of retired managers, executives, and that group, already have quite a few people in Poland. I think it's in excess of 10 now. And they are starting to move people into Hungary, and we're talking about Czechoslovakia. And I think we need to expand it and get that known.

Every time I've been over there, and I guess this has happened with you too, they all say we need American knowhow. And I agree. They respect and seem to want to trade with us, and have us invest and work together.

So the more we can publicize it, the better. Another aspect of that is that we are also giving seminars and getting legal and accounting groups to have seminars with the nationals in both Poland and Hungary. And I think right now we are setting one up in Czechoslovakia. We're doing all this to help, and we need to do more. We need to publicize it too.

Chairman **Rostenkowski**. Mr. Secretary, some administration officials have reportedly argued that a trade agreement with the Soviet Union or other Eastern European countries could take the form of an executive agreement, thus bypassing the congressional approval process.

I asked our Trade Representative, Ambassador Carla Hills, yesterday for her views on this.

What is your view of the appropriate role of Congress in the approval of the trade agreement reached under the authority of the Jackson-Vanik statute?

Secretary **Mosbacher**. Well, trade agreements are the USTR's primary function. But as far as I know, they, and certainly, we too, intend to and want to work with you, and consult and make sure this is a team effort.

Chairman **Rostenkowski**. Mr. Gibbons.

Mr. **Gibbons**. Mr. Secretary, it has to go further than consult. It has to go in there for approval, as I interpret the law. If you want us in on the landing, you better get us in on the takeoff.

Now, Mr. Secretary, I'm encouraged by your words, but I am disappointed at our Government's action, and I'm in the Government too, so I don't want you to think I'm criticizing you or being partisan.

But, as I look around, your foreign commercial service, particularly in Eastern Europe and in all of Europe, is vastly undermanned and vastly undersupplied with the resources that they need to really protect our opportunities in those markets.

I also am worried that we've got the call of a millenium. This opportunity of helping millions of people move to freedom may not ever come again in the next millenium. And if we fail, all of mankind is going to have a terrible burden.

The little things that I've seen that the administration has done so far—our Government, I should say, has done so far—really disappoint me. We are prepared to fight a hot war, but we are not prepared to win the peace. We just have no institutions that have any contingent plans, that have any contingent resources available to go out there and win the peace.

Now, that is not just your fault or the administration's fault, it's our fault. And we need to work together in getting it put together.

But I read that the President wants to send 60 Peace Corps people to teach English in Czechoslovakia. I could use that many in Miami or Tampa. That's a drop in the bucket. You know, they are getting lost over there.

We are just not moving fast enough. I think the chairman has a good idea in the Freedom Corps. There are lots of people in America who could help these people with freedom.

One of the things that I was impressed with when I met with some of those leaders over there was, they said don't send us money, don't lend us money. Good Lord, we don't know how to spend it. We would just blow it. What we need is know-how. We needs hands-on training.

You mentioned accounting. That's fine. They need some training in law. They need some in just how to run a private business. They haven't had any experience with it. And I just don't see us mobilizing the American resources.

That's a large statement I've just made. Maybe you would like to comment on it.

Secretary **Mosbacher**. Yes, sir. I think that—and I share some of your frustration—I agree with the part of your statement that says, you know, these people keep telling us money isn't the answer——

Mr. **Gibbons**. That's right.

Secretary **Mosbacher**. Even if you had plenty of money.

The answer is, I also agree, the skills of management, not necessarily the skills of building something because——

Mr. **Gibbons**. That's right.

Secretary **Mosbacher** [continuing]. In many of these countries, these people are very skilled workers. As a matter of fact, in some areas at least as skilled as we are. But they don't have the idea of autonomous management teams within plants and the sort of things that are normal to us in both small business and large.

Mr. **Gibbons**. Decisionmaking, responsibility acceptance, and how to make a profit.

Secretary **Mosbacher**. Yes. These legal, accounting, and management teams that we are talking about, we agree, are the keys. We are setting these seminars up. We want to do more. We are talking with them about expanding this. The IESC is a good group. There is no reason to make it exclusive. I mean when I say make it exclusive, let's broaden it, and we will work on it.

Mr. GIBBONS. Well, when I look at the proposed budget in this area, I see zilch really. I don't see that we are gearing up for it. And I don't mean in spending money or giving them money. I mean in mobilizing free world manpower, particularly U.S. manpower—and by that I mean men and women, of course—to get over there and get the job done.

We need to bring students over there. We need to bring business types over there. We need to send them people. We just need to teach them how to ride the bicycle is what it amounts to.

Secretary MOSBACHER. I agree with you, sir. We also have already started in Czechoslovakia banking and in the journalism area for what benefit that may be. And exchanges between the two countries, and I think that can be very helpful.

Mr. GIBBONS. I also want to make a suggestion while I've got you in. It will be brief because the light is about to blink on me.

I think I would support a plan to pull all your foreign commercial services out of the embassies and consolidate them under some leader in Brussels. I'm talking about the foreign commercial services in the 12 countries over there.

Your people are still being mistreated by the embassies. They are still not being given the kind of support they need, and there is just not enough of them there. We worked with that idea some, Mr. Secretary. I throw that out on the table and will let you think about it awhile before you have to respond to it.

Secretary MOSBACHER. If you don't mind my responding, if I think too long, I might get a headache. [Laughter.]

I will say according to the people as I visit with them, they are being treated better by the State Department than they ever had in the history——

Mr. GIBBONS. That ain't saying much though. [Laughter.]

Secretary MOSBACHER. It's moving in the right direction. I think the leadership in the State Department, and not just the Secretary of State, who happens to be an old friend, but on down has been cooperative with the commercial service people. And also more and more, the Ambassadors see themselves as part representative of American business, and American people as a commercial base also, not just as a diplomatic base.

So I feel like it's moving rapidly in the right direction, perhaps never as much as we would all like to see. But it has changed so much that I think we can look forward to working together with the State Department in closing whatever gaps are left.

Chairman ROSTENKOWSKI. Mr. Frenzel.

Mr. FRENZEL. Thank you very much, Mr. Secretary, for your excellent testimony.

Concentrating first on Eastern Europe, you have indicated that we are working on the MFN and wanting to work with this committee and the Congress on that as well, that OPIC has led some missions and hopes to get authorities to work in some of these states. And, of course, the states themselves are undertaking some reorganization, particularly with their currencies so that we will be able to trade over there.

There is, however, one extraordinarily difficult level of Government interference called the Export Administration Act, which makes it very difficult for United States companies to do business in Eastern Europe and, in fact, in Western Europe.

I understand that your agency is—that your Department has taken a leadership role in trying to move the administration into a more rational posture on the implementation of the existing act. And I applaud you for that.

It is pretty silly to say we are going to help these people if we do not give them the very things they want, to process controls they need to bring their manufacturing up to speed, the computers that they need to run their factories and their professional organizations.

Can you tell us if, in addition to the work you are doing on trying to improve the implementation of that act, whether the administration is contemplating suggesting changes to us in the act because it expires, as you know, this fall?

Secretary **Mosbacher**. Well, we are moving in this area. First of all, within the administration, we have raised the level of technology that we are willing to shift to a higher grade than we ever have before, and are moving to increase it.

We see that particularly with Poland and Hungary and, as a matter of fact, as we speak, I believe in Czechoslovakia, they are reviewing it in their highest council in Government, that they have offered to let us verify any high technology that goes to them, inspect and oversee that they do not use it for transshipment or for dual use. And by agreeing to that, although we haven't completed the contract on it, it looks like we certainly will shortly, we believe that it's fair to raise the level of technology that can go to these East European countries to a much higher level than at this point the U.S.S.R.

And the differentiation is because of the steps they've made, and certainly hope, down the line, the U.S.S.R. will too. But we are planning to move ahead in that. We are working with the COCOM nations toward a common ground where we can stick together. And we want them to agree to the differentiation, but we also want to have a level that protects our national security.

Mr. **Frenzel**. I thank you.

I want to congratulate you for your leadership in this area. I think we have made more progress partly because of that, and partly because the environment is right to make progress.

But, as you know, 2 years ago, the National Academy of Sciences said we had denied ourselves $9.2 billion in exports in the most recent year that they had studied without any significant increase in national security. And I hope you will be able to keep up your good work in that regard.

Thank you very much, Mr. Secretary.

Secretary **Mosbacher**. Thank you, Mr. Frenzel.

Chairman **Rostenkowski**. Mr. Anthony.

Mr. **Anthony**. Thank you, Mr. Chairman.

Welcome, Mr. Secretary. President Bush has set June as a deadline for negotiations of a trade agreement with the Soviets, off to a late start in the negotiations.

And my question is one of whether or not the President will go ahead and sign off on an agreement, even if we don't have sufficient time to guarantee that it is a really strong agreement, protecting all of the national and the business interests in market openings, or whether or not he would be willing to postpone the June deadline to ensure that all the necessary ingredients are put in place?

Secretary MOSBACHER. Well, I think it would be premature to tell you what he will do, Mr. Anthony, in June on it.

The Trade Representatives have been working on the agreement, as you know, and we've been cochairing one of those committees. On the negotiations, they are moving forward. I would say let's wait and see the progress by June.

The President has said he would like to get this completed by June. That's the effort we are making, and we are hopeful it can be.

Mr. ANTHONY. Well, let me just put a word of caution in and encourage you not to use June as an artificial deadline if, in fact, when the agreement is looked at very carefully, which it will obviously after it has been released, if patents and other intellectual property rights and a good dispute settlement mechanism is not in place.

So I just throw that out to you as a word of caution not to—maybe for some PR value in June rather than for some solid sound international trade reasons to do it later after everyone has had a good chance for input.

The Soviet Union has also entered into a number of trade and investment agreements with other countries in recent months, including Germany and the Eastern Community.

Does the administration view these agreements as a floor for what the United States will seek in its agreements with the U.S.S.R.? In other words, here's my concern.

Will U.S. businesses receive treatment that is at least as favorable as the treatment received by businesses in other countries?

Secretary MOSBACHER. Well, we have not seen any indication that we will not. And I consider it part of our effort to make sure that they do.

We, to date, have not had any evidence that U.S. business would not be treated as well. But I can assure you we are going to work on making sure they are.

Mr. ANTHONY. Well, again I would just like to note for the record a cautionary comment that, again, I think it would not serve our businesses well if there are other agreements that have been traded or treated or committed with other countries. And then when ours are compared with them, it looks like we again are at a competitive disadvantage.

So, I just encourage you through your working group to compare them and to make sure that we do have as good a market opening opportunities as any other country would have had.

My final question would be there's this great fear about Japan taking advantage of market openings in Eastern Europe and in the Soviet Union.

Are you convinced that you have everything in place to make sure that if we need any expert credits or credit guarantees to improve our competitive situation, that the negotiations are taking all of that into consideration so that once again we won't be, as Mr. Gibbons said, we'll be there for the landing as well as the takeoff?

Secretary MOSBACHER. Yes, sir. We will be working in Eastern Europe. As you may have heard, OPIC has been into Poland and Hungary. We will be going back in, leading a group with both guarantees as far as political and currency guarantees for American business, and with some loans. And the Eximbank will also be working there and are working there. And we're talking about their moving into Czechoslovakia next. So we are going to make sure that our people have a shot at it.

Mr. ANTHONY. Well, Mr. Secretary, just a closing comment.

Poll after poll and my own indications after talking to business people in my district tells me that you're on the hotseat. Now, you're going to have do an excellent job in terms of negotiating, and you are going to have to convince these business people that they do have a fair and equal opportunity to get into these new markets.

And failing to do that, I think you could be under strong criticism. And it wouldn't have to be from the members of this panel. It will come from the business community that you represent.

So, good luck. You have a strong challenge ahead of you.

Secretary MOSBACHER. Thank you.

Chairman ROSTENKOWSKI. Mr. Levin.

Mr. LEVIN. Thank you, Mr. Chairman.

Welcome, Mr. Secretary.

Are we using every technique that our trading competitors in the European Community in Japan are utilizing vis-a-vis Eastern Europe?

Secretary MOSBACHER. Well, I think we're using every technique available to us that we possibly could short of some sort of subsidy which, you know, doesn't usually work in the long run.

We are trying to bring together, to a greater extent than ever before, a cohesive and cooperative attitude between business, and including labor and academia, and the Government, to work into these countries and help business and these other areas, and help the countries too.

So the American business ends up being in the strongest possible position. That is our aim at Commerce, and it is the President's aim also. So I believe we are using every means at our disposal.

If you hear of anything that you think we could add, or from any companies, we would like to hear them.

Mr. LEVIN. Other than subsidies.

Secretary MOSBACHER. Yes.

Mr. LEVIN. And are competitors using subsidies?

Secretary MOSBACHER. Well, we can't find in Eastern Europe at this point where they are. We are looking at what they're talking about doing. And, you know, if they are, we are going to have to take a look at it.

Mr. LEVIN. If they do, should we?

Secretary MOSBACHER. Well, I think in the real world if we can't get them to stop doing it, which would be by far the preferred route, well, then we have to consider doing it, yes.

Mr. LEVIN. Consider or utilize?

Secretary **Mosbacher**. Well, just take it one step at a time. First, consider. Then let's see what the alternatives are, what it does to the rest of our budgets, and things like that before I finalize a decision on that. Obviously it isn't just my decision. But, even if it were, I would want to look at all the alternatives.

Mr. **Levin**. We don't have any evidence of European Community or Japanese subsidization of their companies to go into countries which participate in Eastern European efforts? We don't have any evidence of that?

Secretary **Mosbacher**. Not any different than our both stabilization fund and enterprise funds which are special funds that are set up to help the private sector that involves starting up over there, the joint ventures or ventures that have nationals in them.

Mr. **Levin**. Do you think our Government effort is as proactive as those in Western Europe or Japan in terms of relating to our business community, our education community? Do you put our effort on a par with the countries of Western Europe, the community itself in Japan?

Secretary **Mosbacher**. Yes, I do. And I think evidence of our being there and having both business groups and, as I said early, the legal and the accounting seminars, along with a comprehensive business and economic agreement are right up there on top.

Mr. **Levin**. Let me just ask you. We haven't talked much about the investment issue.

What do you expect to come out of the 2-day meeting between President Bush and the Japanese Prime Minister?

Secretary **Mosbacher**. Well, I think there will be a renewal of the discussions and obviously the friendship and importance and interdependence of the two nations together first. And then an understanding that there are still some trade problems that need to be addressed. And that to me should be a part of the agenda and I am sure will be.

Mr. **Levin**. Do you see any specific progress coming out of it in terms of trade relationships, any impediments that exist, the problems that prevail? Do you see anything special or specific coming out of these discussions?

Secretary **Mosbacher**. Well, I am not going to try to preempt our President.

Mr. **Levin**. What is our objective in the discussions?

Secretary **Mosbacher**. Pardon?

Mr. **Levin**. What are our objectives in the discussions?

Secretary **Mosbacher**. Well, I'm certainly not privy to all of them, but one has to be improving our trade situation.

Mr. **Levin**. Thank you.

Chairman **Rostenkowski**. Mr. Thomas.

Mr. **Thomas**. Thank you, Mr. Chairman. Thank you, Mr. Secretary, for coming.

In regard to earlier statements, I want to make a couple of comments and then ask you some questions.

If there's any change in the role of Commerce, especially onsite folks overseas, one of the most important things, I think, is a proactive Secretary on site. Nothing helps morale or creates an ability to fit into the scheme of things as having the person who is head of the operation there, having a presence there and a remembrance of what happened there. So I think that is fundamental to making some of the changes, and I would commend you on your being there, and I know you will continue to be there.

The other things that continually marvels me is that after we have digested the understanding that "we have won," sometimes I think we immediately then forget what it is that we won with. And that was the strength of our private sector. And that immediately we want Government to go over there and provide all of the things that really came from our private sector that the Czechs and the Poles and Hungarians want.

Clearly, our job is to facilitate the contact, the structure, the establishment between our private sector and what we hope is the creation of their private sector.

One of the concerns I have is that in building that kind of a lasting relationship, it takes longer, using the metaphor that we pick up today, the takeoff is longer on those kinds of flights but they tend to last longer if you can build those kind of fundamental relationships.

Also, I don't think we should try to create artificial advantages where others have natural advantages. And it's quite clear that in Western Europe there is a physical proximity which some of our companies can duplicate, given an international role; others cannot.

One of my concerns, and my first question, is that it is clear that so-called big business, large enterprises can enter into joint agreements, single operations, and can move fairly rapidly into a relationship in Eastern Europe.

How optimistic are you in terms of a small business role in Eastern Europe over the next several years vis-a-vis the obvious GE's and others?

Secretary **MOSBACHER**. Well, I'm optimistic that the opportunity is strongly there for small- and middle-sized business, as well as obviously for large business.

I think that, as they learn more about it, and what we're doing at Commerce with the United States part of the U.S. and Foreign Commercial Service, is trying to get as much information out with many people in these 47 offices—from these 47 offices around the country as we can. Hold seminars around the country.

But the opportunity is there for them. There is a tremendous unmet demand in Poland's 38 million people, Hungary's 10.5 million, Czechoslovakia's 15 million. The point is that they have the opportunity. They cannot expect to make a quick buck. They have got to go in there and think longer term. If they do that, the chances are big that they can do much.

For instance, in the service area, we've seen what someone like McDonald's has done. There are those sort of opportunities all over Eastern Europe.

Mr. **THOMAS**. I want to make sure I get the record question in on Jackson-Vanik. Everyone is concerned about it. We've got choices of waiving it, suspending it. I think there may be some strengths to the specific requirements that need to be carried out.

Do you have an opinion as to whether Jackson-Vanik—for example, you mentioned that the President has waived it for Czechoslovakia. Is the current structure working for us rather than against us? That is, the short wave or the requirement to go under it for the 10 trade agreements and so on?

Secretary MOSBACHER. Well, I think it works very well. In Czechoslovakia, as of next week, we'll have a team led by USTR that will be setting up a trade agreement following the President's Jackson-Vanik waiver. As soon as we get a trade agreement in place, he will move forward on the Jackson-Vanik suspension.

Mr. THOMAS. One last point, Mr. Chairman, and then I'll quit.

And that is, it just seemed to me that when we wrote the last trade bill, we were so preoccupied with Japan in terms of the way in which we built that trade bill. No one expected obviously what has occurred.

As you go through the process, I hope on the margin you'll make notes as to where the trade bill seems not to be as useful in the current world as we thought it was going to be in the world we thought was going to be here for sometime. Because I think clearly we are going to have to revisit some sections which I think were overly emphasizing our relationship with Japan, perhaps underemphasizing what can occur in Eastern Europe.

Thank you very much, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Rangel will inquire.

Mr. RANGEL. Mr. Secretary, I want to congratulate you for the challenges that you have clearly outlined to us, and ask if an economic assistance package to your thrust of an investment and trade with the dramatic changes that are taking place in Eastern Europe?

I know that everyone believes they are not asking for money, but just want an opportunity to trade. But do you have any dollars attached to your package?

Secretary MOSBACHER. Yes, Mr. Rangel. For instance, I just got back yesterday from Czechoslovakia. And they reiterated what they had said, I think, when the group was over here, that they are not looking for money.

Mr. RANGEL. I know. But I am just asking, is the administration planning to put together an economic package to support this? In other words, there are probably other shops involved.

I mean, has the President put together a team to deal with these new opportunities and challenges in Eastern Europe? I mean it's more than just your Department, right?

Secretary MOSBACHER. Yes, although certainly when we're dealing with the private sector and getting business involved in it which, in the long term, is the way to really help these countries.

Mr. RANGEL. I know that. But I guess what I'm saying is that if business people say, well, it's great, Mr. Secretary, but we need roads, we've got to get the products to the market, and we need the State Department to give some money so that your business people are willing to invest.

I'm just asking whether or not there are other agencies involved that you are working with that may come to the Congress to say that, in order for you to be successful, we are going to have to put up some taxpayers' money.

Secretary MOSBACHER. We sure are. If I somehow gave the impression that the Commerce Department was doing it all, I'm sorry, I didn't mean to. Because we're working very closely with the State Department, we're working closely with USTR and Treasury.

Mr. Rangel. Now, in your close working relationships, have you heard any of your fellow members of the Cabinet talk about bringing some proposals requesting money for this part of the world so that you can be successful?

The reason I'm asking is that as I go to developing countries, all of them want trade and not aid. They want the dignity of being able to trade. They don't want relief.

But the bottom line is that they need a lot of money in order to reach this status to trade. And my chairman has a volunteer retired force, but I'm asking whether or not you have heard anyone in the Cabinet talk about bringing in an economic package that we may be asked to vote on?

Secretary Mosbacher. Well, I would say if you included the Eximbank funding and the funding of OPIC——

Mr. Rangel. No, no, I wouldn't include that. I'm talking about congressional economic assistance, the same kind of packages that we put together for the Middle East.

Secretary Mosbacher. I'm not sure that I really quite understand what you're talking about——

Mr. Rangel. I can't make it any clearer. Will we have to ask the taxpayers to divvy up a little more in order to assure freedom and democracy in this part of the world?

Secretary Mosbacher. My answer is no.

Mr. Rangel. Thank you. Thank you very much because that will leave a lot more for the other parts of the world that need the money.

Thank you, Mr. Chairman.

Mr. Gibbons [presiding]. Mr. Guarini.

Mr. Guarini. I'm rather surprised at that last answer, Mr. Chairman. But I do thank you for your personal involvement and your enthusiasm. I do share the restlessness of my good friend, Sam Gibbons from Florida.

Things have moved like lightning. And, of course, the question is whether or not we are equally as responsive as we should be. And the question that was just asked by Mr. Rangel is very, very important because, in my trip there, I saw in Czechoslovakia an infrastructure that was in place. They had roads. They were never bombed. They were taken over, and they had the same factories and the same homes and the same roads and the same bridges they had in 1939.

What I saw in Poland, a country that was devastated, you have 43 million people that have no telecommunications to speak of, that have poor transportation facilities. And anybody that wants to do business there would need an infrastructure in order to be able to communicate and distribute their product, and without being able to have a good telephone system in place and being able to make instant judgments, as we do in the business world, millions of dollars would be lost. And that makes it a bad investment.

Aren't we doing anything to improve the infrastructure of these countries so that they can lift themselves up? It's not a matter of the private sector alone. I think that we should have our private sector help as much as possible.

But there are governmental things beyond the private sector that we need to help these countries. Otherwise, they won't be able to help themselves.

Can you comment on that?

Secretary **Mosbacher**. Yes. And we are—for instance, in Poland when we were there, they are working with the TDP [Trade Development Program], which is part of the State Department, which helped make a study of the telecommunications area in certain parts of Poland as to what they could do to improve a region that had been in the steel industry and had been very inefficient, and how they could improve it by diversifying.

We also, just last week, had two groups over from our Department of Commerce in the telecommunications area, working with them on a plan as to how to improve telecommunications.

The Department of Agriculture has had people over there, both helping in the agricultural area and the distribution system.

Mr. **Guarini**. But that's talk. They need technology. But they don't have the finances, being a country deeply in debt. And if we're willing to spend billions for planes and weaponry and tanks and missiles, and we're not willing to spend anything to try to put these countries together to make them a viable unit in the world community, I think we are failing a very important opportunity.

And I am just surprised that we are not doing anything more than just talking about it.

Now, in your budget, I understand for administration is $7.9 million over the baseline of last year for personnel. And when you consider what's happening in EC 1992 and in Central America, and in Eastern Europe, I'm just wondering how much more, how much can you really do with $7.9 million in your proposed budget for overseas personnel?

It just seems to me that you are going to a five-alarm fire with a water pistol. And that the intentions are good, but do we have the wherewithal to target these overseas commercializations and do the job that we should do in helping these countries?

Will you comment on that, please?

Secretary **Mosbacher**. Well, as you know, that budget has been very small so it's actually a high percentage increase in the budget there.

Mr. **Guarini**. Not for overseas personnel. I have $7.9 million, and I would just like to know what countries, considering the fact that you have so many countries that are involved, that have come on line now, how are you spreading that $7.9 million over what you were doing last time when the world was a whole different world? And this is a new millenium, and we are failing to take advantage of an important opportunity.

Secretary **Mosbacher**. We are very aware of the problem, and whereas it may not be as much money as we would like to have, it's a whole lot more than we have. And we've got plans to spread it expeditiously and put personnel in each one of these new areas.

Mr. **Guarini**. Well, what countries are you targeting, sir? Are you targeting the same countries?

Secretary **Mosbacher**. We are reopening an office——

Mr. **Guarini**. See, the reason why I say that is I have been involved in this also. And I understand people are willing to go into

Hungary because they have convertible currency, and they have a good distribution center. Czechoslovakia isn't a bad risk at this time. They're coming on line fast.

But the basket cases like Poland, they need an awful lot of help because of their great national debt and their lack of infrastructure. And I'm just wondering how much personnel are you putting into a country like that? If we are willing to spend hundreds of millions of dollars and billions for weaponry, and we are only willing to spend $7.9 million to increase overseas personnel, it just seems to me that we're not doing enough.

Secretary MOSBACHER. That money and the additional people, for instance, we're putting in Poland, and I agree with your assessment that Poland needs help more than the others because it had been decimated.

But what we do with that money is have it act as a catalyst for the private sector to really spend a lot more money helping. And to that degree, it is being successful. And the private sector is going in there, for instance, with plans on telecommunications. It happens to be something we're working hard on.

If they come back and say we would go in there and put in a telecommunication system if the U.S. Government would put in *x* dollars, then, maybe, Mr. Rangel, I'd come back and say, yes, we do need it.

But, so far, we haven't had to go that route and I don't think we will have to. We are aware of what you're saying, and if we have to go that way, we will. But we think we can do it working with the private sector for mutual benefit, first for Poland and also American business.

Mr. GUARINI. Lastly, Mr, Chairman, if I might say, is there——

Mr. GIBBONS. No, I'm sorry, Mr. Guarini. We'll come back to you real quick.

Mr. GUARINI. I'll come back, sir, if I can.

Mr. GIBBONS. Mr. Sundquist.

Mr. SUNDQUIST. Thank you, Mr. Chairman, and, Mr. Secretary, thank you very much for your testimony and for the team you've assembled.

You know, so many people in my district of Tennessee, they see this Federal Government, and they want to know who is representing America. And I don't think there's any question that Commerce is representing America, and I commend you for that.

I've got two or three fairly short questions in the interest of time.

How is the security regime of rules the United States has proposed to the Eastern European countries, how are they being accepted?

Secretary MOSBACHER. Very well. We've already got on export controls agreements that are almost completed or at least well down the line with Hungary and Poland.

We proposed just the other day, after some early preliminary talks with Czechoslovakia, specific controls and guidelines they're working on. As we speak today, we have every reason to believe that they are going to propose this same thing where dual use and transshipment would be precluded, and they would get a higher degree of technology. So we feel good about it.

Mr. **Sundquist**. So, giving them a higher degree of technology is going to allow them to progress a little faster?

Secretary **Mosbacher**. Yes, joining Poland and Hungary, which will also be in that area.

Mr. **Sundquist**. Right. Now, to follow up on my colleague's question.

It seems to me that that question should be asked of the State Department, not of Commerce, that that's State Department's jurisdiction. You are trying to stimulate the private sector, as I understand it, and bring up the technology and create the jobs. Obviously highways and communications are important, but I don't think this Federal Government wants to get involved in high technology. We don't do those kind of things very well.

It seems to me that's the private sector, telecommunication's activities.

Another question is, is the United States the only country at COCOM favoring the differential policy?

Secretary **Mosbacher**. No, we are not the only COCOM country. We have several who agree with us on the differentiation, and we are still very much in the discussion area.

Now, at this stage, there are more who disagree than agree. But we are not out there alone at all.

Mr. **Sundquist**. Obviously there's a problem in the strategic threat between the Soviet Union and Eastern Europe. We do, as I understand it, support a policy that differentiates between Eastern Europe and the Soviet Union.

Would you care to comment on that?

Secretary **Mosbacher**. Yes. I think we have to.

First of all, the Soviet Union at this stage is the only country in the world that can severely damage us militarily. We hope and believe and expect that they will not.

But until we get the kind of assurances that we are comfortable with, and starting with the same sort of things that these other nations have already given us, I don't think we can ship the Soviet Union the same level of technology that they could, and we don't expect they will. But they could use it against us with the sort of military power they have right now.

Mr. **Sundquist**. I think you will find strong support in the Congress for that policy.

Last question. There is a frustration that we all have, and I catch this every weekend, concerning the Japanese and the way they deal with us, the fact that they seemingly always are delaying consideration. And next year it's going to be better.

And I look at T. Boone Pickens, and all he's trying to do to open up the financial markets, and that's, in my opinion, such a clear abuse and obstruction of our investment and our participation in Japan.

And I noted with interest my colleague's question about the President's meeting with the Prime Minister, and obviously you can't and shouldn't probably comment on that any further.

But I hope that you will pass on to the President our frustration, at least mine, with the Japanese. And they have a new Prime Minister, and I think they ought to be running out of excuses. And the American people by and large support open trade policies. But the

Japanese are, in my opinion—our chairman, Mr. Gibbons, espouses this with regularity, but we have just about had it up to here with the bad attitude of the Japanese. And our trade deficit doesn't go down, and they keep promising things.

And I know how tough you are and how well informed you are, and what you've done on this already, and I want to commend you for that, but if you could pass on to the President our frustration with the lack of open policies by Japan, I would appreciate it.

And I thank you for your testimony.

Secretary MOSBACHER. Thank you, Mr. Sundquist.

Mr. GIBBONS. All right. Next is Mr. Dorgan.

Mr. DORGAN. Thank you, Mr. Chairman.

Mr. Secretary, thank you for being here, and thank you for your statement.

I would like to deal with an old subject but one I can't get out of my mind, and it has future impact as well, the FSX.

I could not, for the life of me, understand why the President, the executive branch, and Congress to some extent, believe that an FSX deal with Japan made any sense at all. And I can't understand why we are proceeding with the son of FSX with Korea.

Can you explain to me the thinking that would allow us to allow the Japanese to buy technology from us at one-fourteenth of what it cost us to develop, and engage in an agreement which will require a good many of the jobs in the long term to occur in Japan to build an airplane they should have bought off the shelf from us? And why we're likely to do the same thing with Korea?

Let me tell you my frustration. I read in the papers that Korea says, well, you know, if you fool around here, we'll buy these planes from France. It's a country that sells a half million cars in America. We've got 30,000 troops in Korea. They're telling us they're going to buy planes from France?

Where is our nerve and where is our backbone? And Japan sells 3 million vehicles here. It seems to me if they only sell 3 million Datsuns and Hondas and Toyotas in America, and they want an F-16, we ought to say we make great F-16's. We expect you to buy them from us. If you don't want to buy from us off the shelf, sell your cars and consortia to Tegulciapa.

I don't understand the mentality here on the FSX deal with Japan and what I think will happen with Korea. Can you go through it with me?

Secretary MOSBACHER. Well, I think in the FSX, go back over, what I agree is it's still an important issue and one that I think we ended up with as a very positive issue. And that is we took, first of all, the technology which I was concerned about right from the beginning, and limited the technology flow to them from us that which would be apropos just for this single plane.

We also included a technology flow back from Japanese to us which was, I think, important and had been far too rare previously. And we, by fixing the minimum amount we would get out of this make sure that workers and companies in this country would make a major amount of money out of the project, design, and the production.

Now, the principles of free trade are that you can either buy things anywhere and/or in this case, they were thinking about designing and building their own plane. I don't think they could have done it for quite some time, but that was an alternative.

I remember when we didn't think that they were going to design and build very good cars. And we turned out to be wrong on that one.

So I think we made what started out as perhaps not a totally acceptable deal. By clarifying these things, we made it into a very acceptable deal that was a plus to the United States, not as big a plus as buying off the shelf an F-16. I'm not going to claim that. But I don't think that was a viable alternative.

Mr. **Dorgan**. Why not?

Secretary **Mosbacher**. Well, because we would have to violate the whole trade system, the GATT system and everything else if we said you have to buy F-16's or we won't import your cars. You know, it's tempting, but——

Mr. **Dorgan**. You don't have to say that. All we have to do is understand that.

I mean what I don't understand is I must have missed the course some place in undergrad or graduate school that seems to defy the common sense that suggests that when you do business with someone, there's an implied obligation for them to do business with you in a way that happens to be fair.

When you talk about free trade, I understand the principles that are pursued in free trade by the administration. I support some of them. But it seems to me the result of free and fair trade is to expect that countries like Japan and Korea when they need products, especially when they fall into categories where we produce the best in the world, would buy them from us just as we buy some of their best products in the world.

And yet the minute we start negotiating, we lose not only our wallet but our pants. I don't for the life of me understand how we get into these positions. And I think I understand what you just said that there are certain principles of free trade that don't allow us to even suggest that there is some kind of pressure that they ought to do certain things.

Why should the Japanese buy as much beef from Australia as they buy from us? Shouldn't they buy more beef from us? They certainly sell more cars to us.

Maybe I'm missing something. I suppose all the experts will nod their heads in agreement, but maybe not. Maybe the folks who negotiate these things are missing something.

What do we expect with Korea and FSX?

Secretary **Mosbacher**. Well, on the—they call the FX, so it's confusing in Korea——

Mr. **Dorgan**. What do they call it?

Secretary **Mosbacher**. FX.

Mr. **Dorgan**. FX. What does that mean?

Secretary **Mosbacher**. That's a fighter experimental program.

Mr. **Dorgan**. I see.

Secretary **Mosbacher**. Actually, it is not, though, a design system. It's a production system. And they will buy the first group of planes from us off the shelf, followed by planes that they will assemble over there.

Mr. DORGAN. So it is not experimental, it is buying some off the shelf, we give them the technology to——

Secretary MOSBACHER. Let me retract my X. I don't know what X means. It sometimes means experimental. In this case, I don't think it does. I know it doesn't.

But when we finish this deal, we'll be seeing that it will be nearly 70 percent of all the costs, plus or minus, will be United States

Now, sure, it would be nice to have 100 percent, but 70 percent is a pretty good amount.

In Korea, we found that last year to this year, for instance, our trade deficit with Korea has gone from $10 billion to $6.5 billion. But I think we're headed in the right direction with them, and I think this is a good step.

Mr. DORGAN. Well, I grew up in a town of 400 people so the main street was people doing business with each other. And they have some implied understanding of what to expect from each other. And those same principles, it seems to me, ought not be lost on the area of international trade. It seems to me that we are not getting what we should expect of those that we do business with internationally.

As I look at what we do, FSX and FX, I worry that those same principles are not involved.

Secretary MOSBACHER. Excuse me, Mr. Dorgan. I agree with you that they need to have as open a market as we do. And we're working very hard on that.

Mr. DORGAN. May I submit some questions to you, Mr. Secretary, on this issue in writing? May I submit some questions in writing to you on this issue because I don't have additional time, and I would like to make further inquiry on particularly the Korean issue.

Mr. GUARINI [presiding]. Thank you, Mr. Dorgan.

Mr. Anthony for one question, and then Mr. Moody.

Mr. ANTHONY. Thank you, Mr. Chairman.

Mr. Secretary, H.R. 3600 has been introduced by Congressman Tom Campbell. It would amend section 301 of the Trade Act of 1974 to require reciprocal responses to foreign acts, policies, and practices that deny national treatment to U.S. investments.

It is somewhat related to the area that Mr. Dorgan was getting into, and I just wonder if you have had an opportunity to be briefed on the legislation, if you've established a position on the legislation?

Secretary MOSBACHER. Well, I believe that we must keep our country open for investment with the exception of national security items on Exon-Florio, just as we must keep the rest of the world open to us for investment. And through the years, we have invested and made a lot of money by investing as a private sector around the rest of the world.

When the other countries invest in this country, in most cases it creates jobs. It is not something they're moving out. It is a positive.

So I think that we should keep an open investment system, and it's important, both for our benefit and for the trading system around the world.

Mr. ANTHONY. But specifically have you taken a position on H.R. 3600?

Secretary Mosbacher. I'm not familiar with the details. But if it puts constraints on foreign investment other than the national security ones, I would be against it.

Mr. Guarini. Thank you, Mr. Anthony.

Mr. Moody.

Mr. Anthony. Mr. Chairman, if I could. After you have an opportunity to fully take a look at the piece of legislation, if the answer that you gave changes, could you just clarify it with a letter?

Secretary Mosbacher. Sure.

Mr. Guarini. Thank you, Mr. Anthony.

Mr. Moody.

Mr. Moody. Thank you. Mr. Secretary, thank you for your testimony.

I want to associate myself with the spirit of what Mr. Dorgan was saying to you in the sense that it may not be GATT legal to insist outright that they buy this in order to get that, and I don't think we should do that.

But these jawboning and informal understandings go a long way. And one of the reasons the Japanese have been so successful in targeting key industries is they do that in their own country. They get together and jawbone and talk and agree on a strategy. That is not pure competition in any sense whatsoever. They have a coordination between Government and industry which goes beyond any industrial policy we would ever want to have.

But if we are going to be purest in this game of not tying anything to anything and let every keg stand on its own bottom, I think we will lose out on some very important opportunities.

So I would subscribe to much of what he said. My question, however, is on a different issue.

What is the administration's policy with respect to these new Eastern European democracies joining the Bretton Woods organizations, World Bank, IMF, GATT, et cetera?

Are we trying to usher them as fast as possible into them? Now, several already belong as I am sure you know. Hungary and Poland, and Yugoslavia, which is in a different situation, already belong to IMF and, therefore, the World Bank. We stopped blocking Poland's entry awhile back. And I think Romania may belong.

But there are a long list of others that haven't yet joined. There's Czechoslovakia, there are other countries, Bulgaria, and clearly they would like to join. Do we take a stand that we will just let that work itself out, or are we trying to run interference more than help them? Are we putting conditions on it, or do we think, for example, that convertibility of currency should be an essential because that forces internal reform on their own country if they start forcing their own currency to be internationally convertible, or just what is our policy, and could you spell it out?

Secretary Mosbacher. Well, our policy is to support their joining World Bank and IMF. They have to meet, of course, the conditions, frankly for their own sake as much as anything else. And as they do it, they are joining it, and we want to help them. We have helped them move toward this. And we are of specific help to Poland and some of the other nations as they move into it.

So it is, yes, it's a proactive help from getting these organizations but, of course, they have to meet the conditions.

Mr. **Moody**. Well, we have, I understand, taken a stand against the Soviet Union joining GATT.

How would you counterdistinguish that policy from the policy you just enunciated?

Secretary **Mosbacher**. No. I believe our position on the Soviet Union is for their becoming an observer of GATT.

Mr. **Moody**. But not a member?

Secretary **Mosbacher**. No, because they have no basis yet—basic costs market orientation that has to be part of the whole GATT system.

Mr. **Moody**. Right. But I mean if they were willing to meet that approach, wouldn't we want to have them join? Unless, you say——

Secretary **Mosbacher**. What did you say?

Mr. **Moody**. If they could meet the conditions of joining, why would we want to hold them in observer status?

Secretary **Mosbacher**. Oh, I don't think we would. Let me say if they meet the conditions, the President has indicated we want to be helpful to them. But they have got a ways to go. That's the point I was making.

Mr. **Moody**. But we are supporting moving each one of those countries forward into the Bretton Woods organizations as their internal conditions permit. Is that our official policy?

Secretary **Mosbacher**. Yes. Yes.

Mr. **Moody**. I see. Thank you.

Mr. **Guarini**. Thank you.

Mr. Crane.

Mr. **Crane**. Thank you, Mr. Chairman.

I guess maybe our colleague has gone who raised the point about his undergraduate or graduate experience. There was something he missed.

I never knew that there was a quid pro quo in the marketplace. For example, when I bought my gas on the way in this morning, I didn't expect that gas station to buy something from me, nor do I expect that when I go to the supermarket, and grow some tomatoes in the summer.

The fact of the matter is if one wants to indict anyone, you can indict all those intelligent Americans who bought those superb Japanese cars, which are quality automobiles. The fact of the matter is, you know, we ought to do a little introspection on our own it seems to me in this regard rather than simply trying to find scapegoats.

I have one concern, Mr. Secretary, about the situation in the Soviet Union where they have had no experience or background with a market economy. And it's my understanding that, based on some testimony that we've already heard, that all restaurant investment in the Soviet Union is screened by a governmental trade monopoly for compatibility with a 5-year plan.

Is that your understanding?

Secretary **Mosbacher**. No. You mean by a Soviet trade group.

Mr. **Crane**. Yes.

Secretary **Mosbacher**. Well, things are changing so rapidly there, I think part of the problem, some businesses in this country have told me, is they can't find who to talk to. So it's in a state of flux.

I have no knowledge they still have that system where they screen everything. I think it's changing rapidly.

Mr. **Crane**. Well, that's encouraging.

The one element that struck me in the Soviet Union that would have any understanding of market economy principles are those people engaged in the so-called black market. It has always struck me as an interesting pejorative description what is business at its best, and that is transactions in the marketplace where people are satisfied with the exchange.

And they do obviously have people over there who have had that kind of experience on the streets. I have not visited but I understand that, prior to this new enlightenment that has overcome them, that there were entrepreneurs that would pay as much as the equivalent of $70 for a pair of U.S. jeans. So someone was in turn willing to buy presumably from that middle man.

So I encourage you in your efforts and commend you for all you have done thus far. The only concern I have is that we not be put at any kind of a disadvantage vis-a-vis some of our European trading partners. And that we would proceed with some dispatch to capitalize on this opening and opportunity, and see American businesses go over there and make a buck even if there is no quid pro quo.

Thank you.

Mr. **Guarini**. Thank you, Mr. Crane.

Mr. Archer.

Mr. **Archer**. Thank you, Mr. Chairman.

Mr. Secretary, I, of course, must admit to a little bias since I have known you for 25 years now, and have a great deal of respect for you. But I do want to welcome you to our committee, and I want to compliment you on your testimony and on the job that you're doing. It's not an easy one. It's probably the most difficult job any Secretary of Commerce has had maybe in the history of this country because of the fast-moving events and the complexities and problems.

I have talked to you a little bit in the past, and haven't gotten brought up to date in the last 9 to 10 months. I'm curious as to how you feel about our capacity to deal with unfair trade practices, such as dumping, particularly with a view toward the domestic manufacturer who could very well be put out of business. And then by the time relief comes in the form of countervailing duties, et cetera, it is not going to help that individual who has been so severely damaged.

And whether there are any changes that you would recommend to us legislatively, or any comments that you would like to make to the committee relative to that issue?

Secretary **Mosbacher**. Well, in the antidumping countervailing duty laws, we've got a very good section in the Commerce Department that we have been working closely with who are very well enforcing those antidumping countervailing duty laws. And I think a lot of being effective in this is shortening the timeframe for when the complaint is first lodged to giving some relief, if it's justified.

And we have done a lot to shorten that timeframe. We find that by doing that, small companies who couldn't afford to file these because they drag on so long, now can come in with an antidumping complaint. And if it's valid, we move on it quickly.

So I think we have made some real progress. The only thing we are studying now is the possibility of covering prospective damages. And we are reviewing that. I don't know whether this could be valid. But the point is sometimes if you wait until the damage is already done, it's gone so long that you haven't helped the company yet. You haven't been able to help the company in time to save them.

Mr. ARCHER. Well, have you given any thought whatsoever to the possibility of taking the financial benefits to the U.S. Government out of countervailing duties when these extra revenues come into the Treasury, and creating a pool that would be available to in some way compensate the injured domestic manufacturer because there is no recourse today that I know of for an injured domestic manufacturer to in any way be made whole or even partially whole.

Secretary MOSBACHER. That's right. That's why we've—two things. First, we've already shortened the time period so that he doesn't get damaged too long or he or she or the company doesn't. And, second, we are reviewing, and may or may not come back to you depending on how we view the legalities of whether we could see what prospective damages could be taking place, even though it's only in an infant stage of reviewing that.

Mr. ARCHER. Do you feel that section 406 could continue in sort of an antidumping area, do you feel that section 406 is an effective remedy for unfair imports from nonmarket economies?

We have a lot of difficulty on this committee in getting a handle on how we should work with the nonmarket economies.

Secretary MOSBACHER. Well, it is a problem obviously because they don't have the same measure of cost. They don't really have any measure of cost. It's one of the reasons the whole Communist system has fallen economically. Because they had no way of finding that their costs were higher than the value of the whole product.

We are aware of that. In some cases, you would assign a cost that would equate to what another group of cost-oriented companies would do.

Mr. ARCHER. Will you possibly have any recommendations to us for any legislative changes in that regard?

Secretary MOSBACHER. We are reviewing it and we'll get back with you on that.

Mr. ARCHER. OK. Thank you very much, Mr. Secretary.

Mr. GUARINI. Thank you, Mr. Archer.

Mr. Pickle.

Mr. PICKLE. Thank you, Mr. Chairman.

Mr. Secretary, it's good to have you with us this morning. I want to make several observations.

One, I know the administration is recommending reducing the amount of funding for the Eximbank from some $612 to $400 million. I think many of us in Congress question that because we ought to have the best means possible of exporting our goods. And I particularly am concerned that the Special Trade Representative negotiate the best agreement she possibly can to see that our goods are allowed access into the European Community, not only just for turbine motors. I think it is terribly important and I hope the USTR and your Department can work close together.

Now, the point I really want to commend you on is this. I appreciate your personal interest in the high-technology area, I mean your interest in trying to go for it as best we can in the research and development field.

I know you were in Austin, TX, recently to visit Sematech where we are doing some of the most advanced work in the field of semiconductors in the United States. And I know your personal commitment to try to do more in the field of research and development.

It seems to me if we don't maintain R&D, and it is being recommended by the administration, I think then we are going to get behind on our goods, both sales locally and internationally.

So I hope you can maintain that interest and convince some of the people in your administration that we must not cut back on R&D. We must make these R&D credits permanent, and we must approach this thing with a great deal of vigor to maintain it.

So I thank you for your interest, and we were proud to have you in Austin at Sematech and we hope you can come back.

Secretary **Mosbacher**. Thank you, Mr. Pickle, and, of course, thank you for your interest in it. I agree, it is absolutely essential that we continue things, Sematech being an excellent example of what we could do with the private sector and Government working together in R&D. The President is extremely interested in continuing this R&D effort. I don't see any indication of cutting back on it at all.

Mr. **Pickle**. Well, I think that as a Nation we ought to announce a firm high-technology policy as best we can. It's always difficult to do these things, just put them into words. But we must make a commitment for a permanency on these R&D credits so that those who would invest in the long term will do so and do it with some certainty. And I think we must encourage these joint ventures in the fields of research and development.

It's terribly important. I heard one of my colleagues today say we ought to leave that to private industry. I think it is much more important than that. I think the Government and private industry must form a partnership in a lot of these joint venture efforts if we are going to be successful. I hope you all can maintain that interest.

Secretary **Mosbacher**. Thanks.

Mr. **Guarini**. Thank you, Mr. Pickle.

Mrs. Kennelly.

Mrs. **Kennelly**. Thank you, Mr. Chairman.

Thank you, Mr. Secretary. We watched Mr. Havel and the wonderful happenings of last week and all welcomed the fact that the President almost instantaneously granted most-favored-nation status to Czechoslovakia.

And, of course, we are closely following the request of the administration to give most-favored-nation to the Soviet Union.

I have legislation, Mr. Secretary, that would extend most-favored-nation status to Bulgaria, Romania, and East Germany. I wonder if you would comment on the administration's position on this legislation.

Secretary **MOSBACHER**. Well, we're interested in helping these nations as well. I think, unfortunately, it may be a little premature at this moment until we see what happens in the elections and how these things settle out and, most importantly, how they either codify or give other strong indications on their immigration clause. We are all headed in the same direction. I think it is just a question of finding a level of comfort that these nations are following through on their democratization, in particular their immigration.

Mrs. **KENNELLY**. Well, I've had that answer given to me by others within the world of trade. And all of us are obviously very interested in improving our position.

I wonder how the administration can really, as far back as the summit at Malta, say that we should grant MFN to the Soviet Union. And yet they really haven't had some of the things that have happened in East Germany or Romania, some of the real people promotion for reform and change. Yet the administration is still pushing for the Soviet Union to get most favored nation, and not for these other nations.

Romania in particular spilt blood to get where they are today. Mr. Gibbons isn't here, but as our chairman of the Subcommittee on Trade always so eloquently says, we have to hold out some hope to these people that these sacrifices are worthwhile. Why is it all right to give MFN to the Soviet Union that really has had not too many reforms that I can see?

Secretary **MOSBACHER**. Well, I don't think there is any intention in the administration to hold the Soviet Union above these others at all. It is a question of working on all of them.

I have been to Poland, Hungary, and Czechoslovakia. I haven't yet been to Romania, Bulgaria, or even East Germany. I hope to go to East Germany next month.

Mrs. **KENNELLY**. Mr. Secretary, Romania is claiming that nobody goes to Romania. Now, I bet they would welcome you. I'm sure of it.

Secretary **MOSBACHER**. Well, I'd like to go. They seem to be a little more in a state of flux. But maybe they are further along than I realize, and we'll check on it

Mrs. **KENNELLY**. Thank you, Mr. Secretary.

Let me take up another area—COCOM, and the areas of computer and telecommunication and machine tools. That list—I don't believe it's been updated since 1974. And I know the administration has said that they would bring it into the world of 1990 and not leave it in 1974. And yet I don't see much advancement.

In the area where I'm from, New England, we have always been leaders in machine tools. In fact, your predecessor was very helpful to us and tried to resolve some matters there.

And I just wonder, would you tell me again that you are in fact committed to updating the COCOM list of machine tools?

Secretary **MOSBACHER**. Well, we're working with our COCOM allies on a machine tool level.

As you know, we did bring the machine tool level up considerably just 6 weeks ago. But we are now in the midst of negotiations to bring it up further from there. And we share your concern that American companies be competitive and be up to speed and allowed the same level.

So it's in the COCOM. It's being debated today

Mrs. **Kennelly**. Mr. Secretary, what I'm worried about is that our allies, who are moving forward and really progressing rather nicely toward 1992, are going to think that we are continuing to use the list strategically rather than economically if we don't update in a more realistic fashion.

And I just think we really shouldn't. If we are going to be in that very sophisticated new world of trade with Europe 1992, I think we have got to bring this forward.

Mr. Chairman, may I submit further questions for the record on this subject?

Mr. **Guarini**. Certainly

Mrs. **Kennelly**. Thank you, Mr. Chairman.

[The questions and responses follow:]

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COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, DC 20515

March 5, 1990

The Honorable Robert A. Mosbacher
Secretary of Commerce
U.S. Department of Commerce
Washington, D.C. 20220

Dear Mr. Secretary:

In order to complete the record of the hearings on examining trade relations with the Soviet Union and Eastern Europe, the implications of "Europe 1992" on American direct investment, and foreign investment in the U.S., at which you testified on March 1, 1990, I am forwarding some follow-up questions from Representative Kennelly and would appreciate it if you would respond to them. Please supply these answers to the Committee office, 1102 Longworth House Office Building, to the attention of Diane Kirkland, by Monday, March 19, 1990.

Thank you for your cooperation in this matter.

Sincerely,

Dan Rostenkowski

Dan Rostenkowski
Chairman

DR/dk

Enclosure

Questions for Secretary Mosbacher

1) The White House and the State Department announced a commitment to streamline the Cocom list in areas of computers, telecommunications, and machine tools. It is my understanding that there is still a great deal of disagreement within the Administration as to what level of machine tool technology to allow to be sold to the Soviets. As you know, the machine tool list has not been revised since 1974. Can I have your commitment, Mr. Secretary, to push your bureaucracy to come up with significant changes in the machine tool list to bring it in line wit the strategic reality of 1990 instead of 1974?

2) Are you willing to make this case to Secretary Cheney and the Defense Department as well, since DoD has been the major force opposed to revision up to now?

3) Do you really think we can keep the support of our allies if we continue to resist any significant cuts in the CoCom list, except in computers where we are most competitive?

4) Don't you think the Germans are going to begin to believe that we are using CoCom for economic rather than strategic purposes when we refuse to streamline the machine tool list where they are most competitive?

5) Doesn't our refused to revise our list mean that our trade competitors are likely to get most of the new machine tool orders, since they are most likely to make a liberal interpretation of what is now a rather ambiguous list of restricted products? That certainly has been the history of licensing for the past ten years. Our market share has steadily dwindled. In 1989, the U.S. machine tool industry sold just over $1 million worth of products to the Soviet Union, while Germany and Japan sold hundreds of millions of dollars worth of machine tools to them. Don't we need to revise the machine tool list for competitive as well as strategic reasons?

6) Mr. Secretary, last week the State Department testified in another Committee's hearing that everything is proceeding very well in the CoCom negotiations. I have heard that the Defense Department is blocking our country's ability to come to an agreement with our allies. Which of these stories is correct?

Thank you.

UNITED STATES DEPARTMENT OF COMMERCE
The Under Secretary for Export Administration
Washington, D.C. 20230

September 13, 1990

Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I have been asked to respond to follow-up questions to Secretary Mosbacher's March 1, 1990, testimony before your committee on trade relations with the Soviet Union and Eastern Europe, the implications of "Europe 1992" on American direct investment and foreign investment in the United States.

As you know, these follow up questions were posed prior to the June 6-7, 1990, COCOM High Level Meeting (HLM). At the HLM, COCOM agreed to a comprehensive approach to respond to the recent changes in the strategic threat posed by the Warsaw Pact. On July 1, 1990, the Department of Commerce issued regulations implementing the changes in the export control system agreed to at the June HLM. I believe that the concerns raised by your committee were addressed by the positive results of this historic COCOM meeting.

One of the primary components of the June HLM agreement was a significant relaxation in export controls on machine tools. Under this agreement, machines necessary for modern civilian manufacturing have been made available to all proscribed destinations. However, machine tools of the sophistication involved in the Toshiba-Kongsberg diversion in the mid-1980's remain controlled. The main features of the machine tool agreement are as follows:

- o Decontrol of the new generation of 32 bit numerical controllers (consistent with changes in the embargo on personal computers).
- o Decontrol of industry standard machine tools with positioning accuracies to the +/-2 micron level for grinding machines, +/-3 or 4 microns for milling machines and +/-3 microns for turning machines.

These two major changes will permit the export, with no prior U.S. Government approval, of approximately 75 percent of all advanced machine tools produced in the United States. Under prior controls, 80 to 90 percent of these machines were controlled.

The United States is now preparing its core list proposal for submission to COCOM in mid-September. While we anticipate that the COCOM core list will further streamline export controls on machine tools, we are not now in a position to determine at what levels the new controls will be set.

Sincerely,

Joan M. McEntee
Acting Under Secretary

Mrs. **Kennelly**. Thank you, Mr. Secretary.

Mr. **Guarini**. Mrs. Kennelly, thank you very much.

Mr. Gibbons.

Mr. **Gibbons**. Mr. Secretary, I want to reinforce what Mrs. Kennelly was saying. I think COCOM is a mess, and the sooner we get rid of it, the better off we'll be. I realize there are some goods we just ought to embargo to Russia that will really affect their ability to wage war.

But I think the list is far too long. I'll give you an illustration of what I saw with my own eyes.

I was in Hungary a few years ago with members of this committee. We went into the Roba axle plant in Hungary and it was all full of American machine tools. Those machine tools were being driven by German computers because we wouldn't sell them the complete outfit.

I came to one manufacturing line—it was just a duplicate of the other lines—and I noticed they had removed all the tools. I asked the plant manager, why are you removing all the tools? He said, well, we're getting some better machines that are fully integrated with computers. I said, are they going to be American machines like the ones you have in your plant? This is a big plant, employs 5,000 people working around the clock. State-of-the-art technology, exports axles to the United States and other places.

He said, well, Mr. Gibbons, I hate to tell you we're going to buy Japanese machines because they will sell us a completely integrated machine and the United States won't.

We also found, when we were in Austria, that the Ambassador there—and she is no longer there—was using your Foreign Commercial Service employees to run around and check on people that had bought American equipment to find out whether it was still in their plant, or whether they had exported it to an Eastern bloc country.

Well, you know, nobody—with all these Americans running in their plant harassing them about what they're doing with the machines—is going to buy any more American machines, and they didn't.

I really think that we have made a terrible mistake with COCOM. We have been snookered by the rest of the world in that crazy annex to the American Embassy in Paris.

As I have said many times, COCOM is a great place to stop if you are on the way to the Crazy Horse. I know that someone like you has never been to the Crazy Horse [Laughter] and I don't recommend it. I've been there, but I don't recommend it. [Laughter.]

I just think we are being fools believing that everybody else in the world is following these crazy COCOM rules except us. I know that you haven't been too sympathetic to COCOM, but the Prince of Darkness in the Defense Department has, and some of those people are still harassing us about those rules. But they just don't work. And we are being made a bunch of suckers all around the world by those COCOM rules.

You've heard me preach enough.

Mr. Secretary, our chairman came up with an idea here of forming a freedom corps. And there are some of us that are beginning to work on that idea. We would like to work with you. Roughly, we would recruit American people with knowhow—retired, active, and even teachers—who would serve with no direct pay from the United States, sort of under the supervision and direction of your Foreign Commercial Service. We haven't thought out the idea entirely. We are going to develop it a little longer.

Maybe we will call on you to help see what we can do to harness the great volunteer spirit that I think is America to teach the people of Eastern Europe and Russia how to set up free institutions, free economic institutions as well as political institutions.

I think we can do that. I think there are a lot of people in this country that would like to help if they could be called upon and their energies harnessed. We are not ready to float anything in that area yet, but we would like to work with you on that.

Secretary MOSBACHER. Mr. Chairman, I would very much like to work with all of you on that. And we have thought a little about the same way, and we don't have it pulled together either. So maybe we can combine our thoughts and see if we can't develop something.

I agree with your ideas, all of your ideas, and the principle also. So we will look forward to working with you on it.

Mr. GUARINI. Thank you, sir.

Mr. Pease.

Mr. PEASE. Thank you, Mr. Chairman.

Mr. Secretary, delighted to have you here again. I'm sorry that I was not here for your testimony. Perhaps the interest that I have has been covered by others. If so, just say so.

But I guess I would just like to emphasize again, as I have in the past, and I think perhaps some of my colleagues have this morning, the importance that we in the Congress attach to the Foreign Commercial Service and to the aggressive use of our Foreign Commercial Service.

Can you, if it's not duplicative, tell me roughly what the magnitude of our presence in terms of Foreign Commercial Service in the countries of Eastern Europe?

Secretary MOSBACHER. In total, we are adding 80 technical and professional people to the Foreign Commercial Service around the world. These are the biggest single—part of these are going to Eastern Europe, but they are moving all around the world. We have got, of course, huge trade with not only Japan, but the other Pacific Rim nations, and we're building trade with Mexico and much of Latin America.

So, if I had more people, we would send all these to Eastern Europe. But percentagewise, we are sending a large group there. We agree with the idea that we want to build commercial service there. We are getting more—as I said earlier, we are getting more and more very good cooperation from the State Department so that we are actually getting use from the Ambassador and his staff, as well as our own Foreign Commercial people. And we are very aware of what you are saying, and we are, I think, moving in the same direction.

Mr. PEASE. Could you give me an idea of how many people we currently have on station in Eastern Europe?

Secretary MOSBACHER. I think we now have in—now, these are high-level people, not the people that, you know, service to them—

we've got 11 U.S. and FCS staff in Eastern Europe now. And we are adding six more. As I say, you could either look at it and say, well, that's not nearly enough. But, as you can see, it's over a 50-percent increase.

Mr. **Pease**. That will be about 17. Do you have any notion at all of how many commercial people the Japanese have in Eastern Europe?

Secretary **Mosbacher**. No, I don't.

Mr. **Pease**. Would you guess it's more or less, more or fewer than 17?

Secretary **Mosbacher**. I tell you what I will do. I will do better than that, Mr. Pease. I will try and find out and let you know because I am interested to get the word to you and I would also like to find out.

Mr. **Pease**. Well, thank you very much.

Mr. Secretary, we think your attitude is a good one. We like the approach you are taking to your job. And as one member, I just want to encourage you to keep up your efforts to strengthen and expand the Foreign Commercial Service.

Clearly, we are being outgunned in many, many markets by the Japanese, and I suspect by the Europeans as well. And if we are going to catch up and reduce our trade deficit further, it seems to me essential that we get more troops out in the field in order to help us do that.

Thank you, Mr. Chairman.

Mr. **Guarini**. Mr. Secretary, the point I was trying to get at before is in order to build up these and make them be competitive, we have got to put institutions in place. It is not necessarily spending money, but we have to do something in order to develop political institutions and private institutions. Everything is done by the Government. Everything is owned by the Government in these countries in Eastern Europe. They don't have a Red Cross. It's the government that has the Red Cross.

They have no institutions as support. The banks are publicly owned. And I'm just wondering whether or not, like we did in Bretton Woods where we set up the World Bank, there should be a specific institution with regard to a development bank.

Has any consideration been given to it where it could apply itself and target itself to the specific problems that exist in Eastern Europe? It's rather unique place at this time in history.

And I am wondering whether or not your Department or anyone in the administration is working toward developing a development bank in Eastern Europe that could help to give the support that their economy needs?

Are there any economic institutions that you have in mind?

Secretary **Mosbacher**. Well, as you know, Eastern Europe and the SEED Program that the Congress passed will do that. But we do it on a country-by-country basis.

And I think that the funds that have been appropriated by both this country and the other Western nations and Japan, can do a very good job, and they are, of course, developed for each nation individually, case by case. I don't think there's one that is just for Eastern Europe, although the European Bank is being developed, which we have been asked to join, which would be targeted primarily to the Eastern—the Treasury Department has been most involved with that. I would rather you get that answer from them, or we can help you get it.

Mr. GUARINI. All right.

Well, you know, you say country-by-country basis. That implies that, in some areas, we will be doing a better job than others. Nothing is completely even.

I am just wondering whether or not, in your opinion, an overall strategy for Communist countries that are coming out of the darkness would be more in keeping.

We're talking about Central America now, and we have a lot of countries, Panama and Nicaragua, and the other countries, El Salvador, et cetera. And you are going to be addressing that very soon although this hearing doesn't particularly go to that point.

But our policy there, too, seems to be country by country.

I'm just wondering whether or not we are making a gross mistake by not having an overall strategy. We have a lot of policies, but we don't seem to have particular strategies for these areas of the world.

And I just wonder if you could remark on it?

Secretary MOSBACHER. I feel like we and the administration have a strategy, an active strategy, for helping, for instance, Eastern Europe as we have and are developing even further in Latin America. So you have to balance having a strategy to the area which you say——

Mr. GUARINI. But there are 170-odd different countries in Africa and all the different continents. You do everything bilaterally and as separate strategy for every country instead of being able to really deal with the broad picture.

It is going to be very debilitating. That's the difficulty of your job.

Secretary MOSBACHER. But it's a tough balance. Because we have a strategy and we need to have strategies for the regions. But when you—and I know you've done some of this too—when you go to a nation, they don't think of themselves as a region, they think of themselves very individually as that particular country. And so you have to do some of both, and that's what we're trying to do.

Mr. GUARINI. All right. Thank you.

Anyone else who wishes an additional round of questions? Mrs. Kennelly, Mr. Pease, Mr. Gibbons, Mr. Sundquist?

[No response.]

Mr. GUARINI. Mr. Secretary, we thank you wholeheartedly. You have been, as usual, very explicit and most helpful. We thank you for your cooperation, and we very much appreciate working with you.

Secretary MOSBACHER. Thank you. I enjoyed being here.

Mr. GIBBONS. As we close, let me make this statement. This concludes today's hearings. Our next witnesses will be Secretary Baker and Secretary of the Treasury, Mr. Brady, both of whom are scheduled to appear on April 18.

And that, Mr. Chairman, concludes our hearing for today.

[Whereupon, at 11:53 a.m., the committee adjourned, to reconvene at 10 a.m. on Wednesday, April 18, 1990.]

U.S. TRADE RELATIONSHIPS WITH THE SOVIET UNION AND EASTERN EUROPE, THE IMPLICATIONS OF "EUROPE 1992" ON AMERICAN DIRECT INVESTMENT, AND FOREIGN INVESTMENT IN THE UNITED STATES

WEDNESDAY, APRIL 18, 1990

House of Representatives,
Committee on Ways and Means,
Washington, DC.

The committee met, pursuant to notice, at 10:10 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. The committee will come to order.

Today we conclude our series of hearings on foreign direct investment in the United States, Europe 1992, and United States trade relations with the Soviet Union and Eastern Europe. We have received testimony from a large number of private sector witnesses and key Cabinet officials, all of whom have helped the members of this committee increase our understanding of the complexities in these issues.

We are privileged this morning to have with us Secretary of State James Baker. Secretary Baker brings a unique perspective to all of the issues under consideration today, but particularly the issue of United States trade and economic relations with the Soviet Union and Eastern Europe.

The changes we have witnessed in those countries over the past 12 months have surprised even the most forward-looking observers. U.S. relations with countries of the region are at a turning point. With the proper support and assistance, these countries can make a successful transition to market-oriented democratic systems. However, such a transition will not be easy even under the best of circumstances, and it is crucial that the administration and the Congress do all we can to facilitate the movement toward democracy.

Our optimism about the positive changes we have witnessed in these countries is tempered, however, by signs that within the Soviet Union events may be proceeding in a direction which could hamper the hoped-for improvement in our bilateral relations. I am referring, of course, to the difficult situation in Lithuania, as well as in other regions of the Soviet Union, where pressures for independence are building. How that situation is handled by the Soviet authorities will inevitably have a strong bearing on the attitudes in the United States toward further liberalization of our trade and economic relations with the Soviet Union.

Mr. Secretary, we welcome you to the committee today. We are glad to have you back. We recognize that you have a very difficult job of helping the President manage the dramatic changes in the world today. I want to express my personal willingness and that of the entire committee to cooperate with you and the President in crafting legislative initiatives to respond to our global challenges.

Do any of my colleagues have opening statements they wish to make? Mr. Archer.

Mr. ARCHER. Thank you, Mr. Chairman. I join you in welcoming my old friend, James Baker, Secretary of State, before the committee.

We do look forward to hearing your views and analysis of the very dynamic environment that we find in Eastern Europe, as well as your thoughts on the economic integration of the EC, and on foreign direct investment in the United States. I realize that the topics for this hearing are wideranging, and, indeed, with the tense situation now occurring in Lithuania and with rising concerns about developments in China, we probably are going to have questions on our minds that will take you even farther afield. But we give weight to your judgment and ask for your patience. I hope you will be able to shed some light on the myriad events that make this particular time so exciting, so hopeful, and yet so full of challenges, and possibly troubles.

We have welcomed to this committee earlier Secretary Mosbacher and U.S. Trade Representative Carla Hills to hear their views on the important issues involved around the Uruguay round. This afternoon, we look forward to hearing the testimony of Secretary Brady.

We view your testimony as key to our understanding of the administration's policies in the areas covered by this hearing, especially with respect to Eastern Europe and the Soviet Union. And we appreciate the time you have taken to work with us here today and in the future.

Thank you.

Mr. SCHULZE. Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman. I, too, would like to join in welcoming Secretary Baker and Secretary Brady as well, who will appear later today.

Given the changes under way in Eastern Europe and, of course, the recent developments in Lithuania, Secretary Baker's appearance before this committee couldn't be more timely.

When these hearings commenced in January, before tensions over Lithuania's situation reached present levels, I said that with respect to most-favored-nation status for and a trade agreement with the Soviet Union we must move with extreme caution. For as much autonomy as the Soviet Union has accorded its East bloc allies, it has done so only out of its own economic necessity, as opposed to Mr. Gorbachev's suddenly discovering the meaning of altruism. The real test for me, and for Mr. Gorbachev, is how he handles the call for freedom and independence coming from within his own borders; namely, the Baltic States of Lithuania, Latvia, and

Estonia. I felt Mr. Gorbachev was failing this test in January. I feel that the events of March and April bear this out even more emphatically.

Now, having said that, and with all due respect I have for Secretary Baker and the critical role he is playing, with our relationship with the Soviet Union and as it evolved, I must again urge extreme caution in the area of United States-Soviet trade relations. The United States has survived for many, many years without a comprehensive trade agreement with the Soviet Union, and in the name of freedom could do so for much longer. If the U.S.S.R. wants MFN, and an agreement, it must earn them, and so far it has not.

Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Any further comments?

[No response.]

Chairman **Rostenkowski**. Well, Jim, this committee is certainly no stranger to you. You have worn a different hat on several occasions when we worked together on some major legislation. I just want you to know how much we appreciate the commitment you have made and the work that you have been doing on behalf of our country. Welcome to the committee, Mr. Secretary. You may proceed.

STATEMENT OF HON. JAMES A. BAKER III, SECRETARY, U.S. DEPARTMENT OF STATE

Secretary **Baker**. Thank you very much, Mr. Chairman.

It is a real pleasure for me to once again have the opportunity to appear before Ways and Means, and it is a pleasure particularly to appear before you on a subject other than tax reform.

I am glad to be here to discuss the progress of economic reform in the Soviet Union and in the emerging democracies of central Europe and Eastern Europe. I am also happy, Mr. Chairman, to share with you our thoughts on the ways in which the various reform efforts will affect our bilateral economic relations with each of these countries.

In my written statement, I have gone into some detail in reviewing the state of economic reform in the Soviet Union, and in the new democracies, and in explaining our policy toward the reforming governments. I would ask, Mr. Chairman, that the written statement be entered in the record, and I have a brief oral summary.

Chairman **Rostenkowski**. Your entire statement, Mr. Secretary, will be entered into the record. You may proceed.

Secretary **Baker**. I would like to make several observations, Mr. Chairman, some of which—all of which are not in my written statement that perhaps put my testimony in broader perspective. First, as virtually all of the reformers have made clear, continued progress in reform will depend, above all, on the internal choices that each of these governments and the peoples of those countries make. Western policies and aid can marginally, but only marginally, influence the prospects for reform. The real work has got to be done within the countries themselves.

Second, having said that, there remains quite a bit, I think, that we in the West can do. These economies have so much of a negative legacy to overcome that our help can make a difference. And the potential benefits for these countries—and the potential benefits, for that matter, for us—are great. We in the United States need to remain engaged to help these countries make the transition to market-oriented economies, and to ensure that these countries are integrated into and not excluded from the broader Atlantic community of nations.

Third, I think that we need to be creative in how we define "help," and we need to be flexible, I think, in how we apply it. Few of these countries are interested, really, in outright grants or aid. Instead, most of them are seeking what we would call technical economic cooperation—nuts and bolts help, if you will—about the transition from central planning to market economies.

Fourth, with regard to central Europe and Eastern Europe, I noted 2 months ago when I was in Prague that the historic democratic movements that we are witnessing across Europe hold great promise for all of us, but initial impulses for democracy may not be enough. If 1989 was the year of sweeping away, 1990 really should be the year of building anew.

One challenge confronting the transitional governments of Eastern Europe is organizing and implementing fair and free elections—elections that establish open parliaments with a place for opposition. In Prague, I underscored the necessity for the new democracies to respect the rule of law, fundamental individual rights and liberties, and minority rights. Since that time, free and fair elections have been held in the German Democratic Republic, in Hungary, and in Slovenia, a republic of Yugoslavia. Open, freely contested parliamentary elections are scheduled over the next 2 months in Romania, in Czechoslovakia, and in Bulgaria. And Poland, of course, as you undoubtedly know, Mr. Chairman, will hold local elections for some 50,000 positions on May 27.

Election observers from the United States and other CSCE countries will be following the balloting in each country to authenticate the process. Successes in the political sphere really have to be reinforced by successes in the economic sphere. Because for democracy to succeed in Eastern Europe, it really is going to have to hold out the hope of a better life for the people of this region. Economic vitality in these new emerging democracies is essential to maintaining the stability of Europe.

Finally, Mr. Chairman, with regard to the Soviet Union, this administration has, of course, made it clear for some time that we want perestroika to succeed. Perestroika can help create a more open society. It can channel claims for societal resources away from the military to civilian uses, and it can create institutions not oriented toward military adventurism. In short, perestroika can transform the Soviet Union into a cooperative member of the international community.

We have a national interest in the spread of our core values—values such as self-determination, democracy, individual rights and freedoms, economic liberty, market economics, and the peaceful resolution of conflicts. So we welcome the Soviet Union's movement toward accepting these values. Realism is called for, however, in assessing the actual influence that we in the United States can have on perestroika. We must avoid, I think, the siren song calling for direct aid to Moscow. As President Gorbachev has stated on numerous occasions, the success of the Soviet reform depends on the Soviets themselves. It was the discarded view of General Secretary Brezhnev that Western technology, Western credits and know-how could somehow produce a Soviet economic turnaround.

In our view, the best approach towards supporting both perestroika and America's interests and values is in a creative search for points of mutual advantage in those areas which are most open to superpower cooperation—for instance, making Europe whole and free; resolving regional conflicts; negotiating stability- and predictability-enhancing arms control agreements; supporting the rule of law in the Soviet Union; and working together on technical economic cooperation.

Let me focus here, Mr. Chairman, on the strictly economic aspects of this search for mutual advantage. We have begun a program of extensive technical cooperation with the Soviets designed to facilitate the massive task of restructuring their economy. The President presented a list of possible projects to President Gorbachev when they met in December at Malta. In addition, we are exploring a host of other steps we can take to share our experience across a broad range of sectors.

At Malta, the President also presented a series of bilateral commercial initiatives designed to demonstrate our support for perestroika, serve our economic interests, and in the process help teach the Soviets about the practical workings of market economics. We can continue to challenge Moscow to implement the domestic economic reforms which are needed for increased international economic interaction.

Now, before turning to your questions, Mr. Chairman, I would like to make several points about the situation in Lithuania. The people of Lithuania must not be denied their rights. We, of course, support—as we long have—the aspirations of the Lithuanian people for self-determination, and we have never recognized the forcible incorporation of Lithuania, Latvia, and Estonia. In fact, the Supreme Soviet itself has called the 1939 Molotov-Ribbentrop Pact and its secret protocols illegitimate, effectively making the incorporation illegal.

It is time now, as we have been saying for several weeks, to engage in a dialog. It is time to engage in a dialog and not merely talk about having a dialog. The Lithuanians want such a dialog. So, Mr. Chairman, that, it seems to us, is the answer to the problem—dialog. Not economic boycotts and not threats to invoke Presidential rule.

Mr. Chairman, our policy toward the Soviet Union is shaped by what is in the interests of the United States of America. It is in our interest to see the countries of Eastern Europe free of Soviet forces and secure from threats that could reverse their revolutions. It is in our interest to see the Soviets destroy 40,000 tanks through a conventional forces agreement. It is in our interest to lock in major reductions in Soviet strategic forces and to create a more stable, predictable, and secure relationship that reduces the risk of nuclear war. It is in our interest to settle regional conflicts in a way that fosters peace, freedom, and democracy, as we did in Central America. And it is in our interest, Mr. Chairman, to see the reform process go forward in the Soviet Union so that it will be more committed to internal progress than it is to external expansion.

But some of our bilateral commercial contacts with the Soviet Union may be more directly in their interest than in ours. And those contacts are being put to risk by Soviet actions in Lithuania. Our willingness and ability to take such steps that benefit perestroika in the near term is, to be sure, affected by Soviet behavior. Perestroika, glasnost, and democratization cannot be divisible. They are indivisible. The reform process won't go forward and succeed if it is applied, Mr. Chairman, in some republics but not in others.

Mr. Chairman, I would be delighted to respond to your questions.

[The statement of Secretary Baker follows:]

THE IMPERATIVES OF ECONOMIC REFORM:
CHANGE IN SOVIET AND EAST EUROPEAN ECONOMIES

TESTIMONY
BY
THE HONORABLE JAMES A. BAKER, III
BEFORE THE
HOUSE WAYS AND MEANS COMMITTEE
WEDNESDAY, APRIL 18, 1990

Mr. Chairman, Members of the Committee:

It is a pleasure to appear before you to discuss the progress of economic reform in the Soviet Union and in the emerging democracies of Central and Eastern Europe. It is also a pleasure to share with you our thoughts on the ways in which the various reform efforts will affect our bilateral economic relations with each of these countries.

Before reviewing the situation in detail, I'd like to make three brief observations.

First, as virtually all of the reformers have made clear, continued progress in reform will depend above all on the internal choices each government and its people make. Western policies and aid can marginally influence the prospects for reform, but the real work must be done within the countries themselves.

Second, having said that, there remains much we in the West can do. These economies have so much of a negative legacy to overcome that our help can make a difference. And the potential benefits for them -- and for us -- are great. We in the United States need to remain engaged, to help these countries make the transition to market-oriented economies, and to insure that these countries are integrated into, not excluded from, the broader Atlantic community of nations.

Third, we need to be creative in how we define "help," and we need to be flexible in how we apply it. Few of these countries are interested in outright grants or aid. Instead most are seeking what we call technical economic cooperation -- nuts and bolts help, if you will, about the transition from central planning to markets.

With these three points in mind, I'd like to turn now to discuss the state of reform in each of these countries, beginning with the Soviet Union.

SOVIET UNION

Since 1985, the Soviet Union has pursued the internal reform policies of "perestroika," "glasnost," and "democratization." Perestroika, glasnost, and democratization -- broadly understood under the heading of perestroika -- are a brew of political, economic, and legal measures. As President Gorbachev has made clear, transforming the Soviet economy requires fundamental change in the political and legal landscapes -- a true "revolution."

The changes Gorbachev has made in the political and legal structure have sought:

- -- a Presidency with wide-ranging powers;
- -- a Supreme Soviet that would enact laws and decrees;
- -- a Politburo and Central Committee that would agree to radical reform;
- -- a bureaucracy that would implement, not obstruct reform; and
- -- a general public that would embrace and sustain necessary changes.

Gorbachev and his allies have had to formulate and legitimize a new Soviet market system -- now called a "planned market." This requires not just a technically sound program, but overhauling the orientation of millions of Soviet citizens. It involves a reconsideration of Soviet doctrine in several sensitive areas. Other members of the leadership are bound to resist this assault on socialist theory and practice. We have seen signs that they could rally some support against the required renegotiation of the Soviet "social contract": The implicit agreement whereby the Soviet people have received extraordinary security and distributive equality (except for the privileged and the corrupt, a growing group), but at the price of political dictatorship, the absence of civil liberties, few economic incentives, and limited economic opportunity.

Perestroika also forces new thinking about the tradeoff between efficiency and equality. This raises the question of the roles of property and incentives. Economic incentive is the prime motivation for productivity, and private property is the key to economic incentive. The Soviets also need to reconsider the role of planners because the information explosion of the last twenty years has demonstrated that a centrally planned economy cannot compete.

As we examine the Soviet reforms, we must keep in mind the vast differences separating Soviet thinking on economic questions from our own. For instance, in the Soviet command economy, output and allocation are set through quantity targets according to a central plan, not by market prices. Prices do not signal scarcity; they are an accounting tool. Rubles are not freely convertible into goods within the Soviet Union, much less outside. In short, central allocation decisions, not money and markets, still command resources.

While the impetus to change may have been economic, it would be a mistake to analyze perestroika as simply an economic phenomenon. The course set by President Gorbachev involves changes throughout society. Much of it is experimental and ad hoc.

Previous Soviet Reform Efforts

Perestroika is not the first effort to reform the Soviet command and control economy. Prior attempts included: the "new lands" policy in the 1950's, designed to spark agricultural production; the Lieberman reforms in the 1960's, a forerunner of current efforts to increase enterprise autonomy; and Brezhnev's increased centralization and bureaucratization in the 1970's, intended to promote management efficiency by increasing cross-sector coordination. All these efforts simply tinkered with the basic Stalinist model, and all failed.

The causes of these failures may help us to understand the conditions necessary for the success of perestroika. These conditions include:*/

1. top-level political support;
2. clear recognition of the need for economic changes;
3. an openness that permits the rethinking of ideology and economic theory so as to justify change;
4. a conducive international environment;
5. consistency in the design and implementation of reforms; and
6. an ability to counter the power of the anti-reform bureaucracy.

As the reformers are taking on Russian as well as Soviet traditions, even these conditions may not totally suffice. Openness may bring conflict as well as progress.

The first four conditions for a successful reform effort are probably present now. But the fifth and sixth pose real challenges for President Gorbachev. At this point, there are a variety of perils facing perestroika. They include: a poorly designed and non-comprehensive program, reflecting compromises among the leadership; poor implementation due to bureaucratic opposition; public opposition due to the loss of benefits from the old system; and the failure to win a constituency for the reform, due to uncertainty about its staying power and legal protections.

Given the magnitude of the challenge, perestroika has been not one reform program, but an amalgam of many. It is an ongoing experiment ever ready to face new challenges, at times in unexpected ways. Yet it has also reflected compromises made necessary by the Soviet system of collective leadership. These compromises and contradictions have created ambiguities, which in turn have opened opportunities for bureaucratic "reinterpretations" and obstructions. It remains to be seen whether the new powers Gorbachev has assumed in the "executive presidency" will overcome these obstacles.

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*/ These conditions are drawn from Anders Aslund's book, Gorbachev's Struggle for Economic Reform (1989)

The Reasons for Perestroika

Perestroika arose in response to problems predating Gorbachev. Command methods swiftly industrialized the Soviet economy, if at great cost. Yet by the early 1980s, the Soviet leadership understood that some kind of economic reform was necessary. Yuri Andropov, in his few months as General Secretary of the Communist Party, outlined measures that became Gorbachev's starting point.

I believe a combination of four factors convinced Andropov and the other Soviet leaders of the need for reform.

The first was the sharp drop in economic growth. Growth rates fell from 5% in the late 1960s to 1.8% in the early 1980s. (Growth may have even been lower, or stagnant.) The period of extensive Soviet economic growth, based on expanding inputs, was over. Yet the Soviet economy could not switch to intensive growth, relying on productivity gains. In part, this reflected Soviet backwardness in developing and employing technology.

A second argument for reform was the declining position of the Soviet Union in the world economy. Instead of catching up with and passing the U.S., as Khrushchev had boasted, the Soviets were falling further behind -- behind not just the West, but the newly industrializing economies (NIEs) also. China, too, was instituting reforms that would leave the Soviet Union behind if it did not change.

The Soviet Union's international trading position was hurt. Even in trade with Eastern Europe, the Soviets were relying more on exports of raw materials. (The fall of energy prices by the mid-1980s exacerbated the situation by cutting into hard currency earnings.) The Soviets were looking at the possibility of being overtaken economically by the Asian Tigers and other Third World nations.

The military impact of Soviet economic failure was a third reason for reform. The U.S. military buildup could only be offset by siphoning off an even greater share of civilian resources. The estimates of the Soviet military's share of GNP vary, from 16%-18%, or even higher. (This compares with about 5% in the U.S.) The growth of Soviet military spending was clearly damaging the economy's ability to produce sophisticated military technology. As former Soviet Chief of Staff Ogarkov stated, technological backwardness would eventually lower military capability as the Soviet economy would not cope with the Western "revolution in military affairs."

The fourth factor was the emergence of new leadership in the Soviet Union -- a new generation. Less rooted in the old system, less dogmatic, some were readier to experiment with new answers. The new leadership understood that the Soviet economic engine required more than minor adjustments. But it was far from agreed on what new reforms were necessary.

Perestroika As Reconstruction

Following Andropov's lead, Gorbachev initially emphasized "uskoreniye" -- "acceleration" of growth through more intensive use of inputs, rather than just massing additional resources. The elements of this program included:

-- higher growth targets;

-- a traditional focus on more investment in equipment, modernization and machine tools;

-- better quality by creating a new quality-control bureaucracy (Gospriyemka);

-- a worker discipline effort, including the anti-alcohol campaign; and

-- new decrees on wages and social benefits to cope with wage leveling and the lost link between performance and income.

The results of this program were unacceptable; growth continued to stagnate. Planning based on higher but unmet targets exacerbated imbalances. Extra investment did not improve efficiency because there were no market signals (prices and profits) to guide the allocation of capital. The bureaucracy rejected quality control because it hurt the ability to meet plan targets, which in turn would reduce bonuses.

While it had short-term positive efforts, the anti-alcohol campaign pushed alcohol production outside the legal system, which led to a major loss of state income from the tax on alcohol, increasing the budget deficit. The wage and benefit rules also turned out to be ambiguous because enterprises still focused on quantity rather than quality or the efficiency of production.

If there was any benefit from the reform, it was the recognition by the Soviet leadership that more drastic action was necessary. While not agreeing on the exact action, they knew they could not sit still.

Broader Based, Piecemeal Reforms

By 1987, Gorbachev was ready to move beyond the Andropovian approach to reform. The result was the introduction of major reform measures -- specifically the Basic Provisions for Fundamental Perestroika of Economic Management and the Law on State Enterprises -- at the June 1987 Central Committee Plenum. These measures addressed a number of sectors and issues of economic organization. While broad-based, these changes were neither comprehensive nor integrated with one another.

While designed to foster more enterprise independence, the planners did not really let go. The absence of competition and market prices meant that decentralized authority led to higher wages, not improved efficiency and quality.

Enterprise self-financing was intended to spur firms to earn their own resources, so that subsidies could be reduced. Without prices reflecting market forces, the profits (or losses) of the firms were hardly dependent on their efficiency and competitiveness. Moreover, central planners, not firms, continued to control credit and other inputs. Instead of going bankrupt, unprofitable firms were still subsidized, which contributed to the growing budget deficit.

Cooperatives were supposed to give a quick boost to sales and production by permitting groups of workers to enjoy the fruits of their labors, which could demonstrate to consumers that perestroika had a payoff. They could also be a first form of private ownership to demonstrate the rewards of hard work and ingenuity. Yet the compromises of the cooperative program produced a legal and business environment that almost seemed to be designed in order to thwart the cooperative movement.

Planners still channeled most inputs to state firms, forcing co-ops to operate through illegal, higher-priced "black" markets. This hurt the public legitimacy of co-ops. In the absence of real competition, many co-ops earned monopoly profits, further eroding public support. The government reacted to this by granting local authorities wide latitude in taxing co-ops, which in some parts of the Soviet Union has led to harsh taxes. In addition, the government forbade co-ops from operating in certain sectors (e.g., medicine, printing) that had proven popular and profitable. What's more, the very tenuousness of the co-ops' existence has led many to distribute profits instead of reinvesting them.

Despite this, the cooperative sector has prospered. According to some Soviet estimates, co-ops now account for about 5 percent of national income and employ about 2.5% of the work force. But the future of co-ops remains uncertain. They remain a prime target of trade union complaints. Last year, the Supreme Soviet only narrowly defeated, 205 to 190, a proposal to close all trading cooperatives.

Agriculture, which led the way in the Hungarian and Chinese reforms, also has proved a disappointment. Although a new idea of "contract leasing" (long-term leaseholds to create incentive for farmers) was announced, the potential leaseholders were harassed through high taxation, refusal to deliver inputs, and a lack of legal guarantees for leaseholders. Moreover, the farmers themselves didn't know how to run farms. Their experience was as day-laborers, not small businessmen. Given the uncertainty of the new incentive system, many people were also wary of the risk of running a farm.

The Law of Individual Labor Activity was a cautious first step toward building a private sector. Yet this half measure limited entrepreneurs to the service sector and kept prohibitions on hiring labor. It was also contradicted by the accompanying campaign against "unearned income -- which cracked down on the same small business the law on individual labor activity was supposed to encourage.

In sum, the piecemeal reforms of 1987 proved inadequate. They did not activate unused reserves or substantially increase efficiency. Government spending increased and revenues fell. The large deficit was financed through printing more rubles, which sent inflation climbing (perhaps as high as 10%, according to some estimates). People no longer trusted the value of the ruble, which led to a hoarding of goods that made shortages worse. The leadership recognized that perestroika must move even further.

Latest Efforts: Two Steps Forward and One Backward?

The next major move came in October 1989, when Deputy Prime Minister Abalkin proposed a two-stage "moderate radical reform" program designed first to stabilize the economy and then to introduce some of the structural changes needed for further reform. This plan represented a major theoretical advance over previous reform efforts. It recognized the importance of:

-- the market, and particularly the pricing mechanism, for regulating the economy;

-- competition, including from imports, to promote efficiency and keep prices down;

-- ownership rights; and

-- institutional change and reform sequencing.

Abalkin's plan, though, was more impressive in theory than in practice. Its endorsement of "ownership rights" did not specifically include "private property." The timing of price reform remained uncertain and the stabilization program was too timid.

Yet even the Abalkin plan was too advanced for the Soviet political environment. As the plan was under discussion, the Supreme Soviet sought to cope with consumer shortages through traditional administrative means like a price freeze and an extension of state orders (as opposed to marked allocation) to essential foods and consumer goods. When it came time to legislate the next stage of reform in December 1989, the Soviet leadership turned to Prime Minister Rzyhkov's tepid program. While retaining the construction of Abalkin's two-step approach, Prime Minister Ryzhkov's ideas for structural reform failed to advance the status quo. Specifically the Ryzhkov program:

-- called for the re-centralization of investment decisions;

-- advocated increased investment for agriculture, instead of reliance on leasing and incentives for production;

-- envisaged a slower pace on price reform, with new wholesale and agricultural prices delayed until 1991 and a failure to commit to a timeframe for new retail prices; and

-- emphasized that major enterprises would remain "within the sphere of direct state management" and expected only 20% of Soviet enterprises to have transferred to leasing by 1995.

In sum, as recently as last December the Soviet officials were proposing increased reliance on the command-planning model as a "step" toward (but in fact away from) a more market-oriented system.

Not surprisingly, the Ryzhkov proposals did not turn the economy around. In the first two months of 1990, incomes rose 14-15%, while production rose less than 2%. Efforts to raise fuel prices for enterprises were met with protests from official trade unions and were rescinded by the government. The result was yet a third economic reform program by mid-March, shortly after Gorbachev assumed the enhanced presidency.

A Council of Minister decree outlined this reform program, which calls for the transition to a "plan-market" economy. The decree lists 28 laws and decrees to be prepared by May 10. Some items on the list are already in the works, including banking and tax reform, anti-monopoly legislation, and amending the laws on state enterprises and cooperatives. Others are new, including laws on freedom of economic activity and the development of entrepreneurship, taxation in kind, indexation of incomes, and reform of price formation.

While the scope of the new program could turn out to be impressive, we have little indication of the content of the laws and programs, or of what stage of the drafting process they are in. This program could represent a major advance over the Ryzhkov plan, but we shall have to see if it improves on Abalkin's October proposals. Indeed recent statements by Abalkin himself, "reassuring" the Soviet public that the proposed changes will not be "radical," suggest that the new program could even fall short of the October 1989 version.

Lessons from Perestroika

Perestroika to date has been comprised of a grab-bag of economic reforms. Some are striking changes from Brezhnev's economic system. Unfortunately, not much has worked in terms of economic performance.

The political changes, however, have been exceptional. Gorbachev has decided that he needs to change the political system to support economic reform. We have witnessed the rise of a Supreme Soviet with real power and of an executive presidency.

The lessons of early failures are clear:

-- The old Brezhnev model was totally discredited;

-- The Andropovian moral discipline fix was a bust;

-- GDR-type streamlining efficiency didn't work;

- -- Piecemeal reforms of enterprises and industrial organization couldn't be successful as long as they operated in a system hostile to private initiative, competition, markets, and profits; and
- -- Even the agricultural sector -- the leading edge for the Hungarians and the PRC -- was impervious to reform.

The positive lesson was there too. To succeed, reform must be economically and politically comprehensive. A comprehensive program might take a number of forms, each with different risks.

There are three kinds of comprehensive strategies: (1) one-shot radical reform all at once, the "Big Bang" approach, perhaps after some basic groundwork is laid; (2) gradual changes, but sequenced carefully to enable reforms to take hold; or (3) major transformation by sector.

Each strategy requires a shift from the ad hoc adjustment of the past. And this is a problem. It will be exceedingly difficult for a collective leadership to develop a comprehensive effort. This is no surprise. It is hard for our decentralized political system to develop comprehensive programs, too. But our basic political and economic system works. The Soviet Union's does not. Some analysts suggest that Gorbachev's assumption of new, extensive presidential powers is designed to remedy this weakness.

What Is To Be Done?

There is some irony in asking, as Lenin's book did in 1902, "What is to be done?" That book called for a tightly knit, highly disciplined party vanguard with strong central control to make a revolution. But in the 1920's Lenin introduced a New Economic Policy (NEP) that envisaged decentralized economic authority, at least as a temporary expedient. Some Soviet reformers seek to trace the antecedents of their market-oriented ideas to that NEP.

Of course, Soviet society is quite different from ours, with cultural, political and ideological constraints unlike ours. And it remains in many ways, as Churchill well understood, an enigma. So any outsider should be cautious in offering advice for reform, That said, some economic points stand out to me personally.

One, there is no getting away from market prices. Whatever the problem, the solution keeps coming back to market prices, which:

- -- enable markets to assess profitability;
- -- guide efficient investment;
- -- allow firms to compete for inputs, not rely on a planner's allocation;

-- signal the scarcity of goods and create incentives for production;

-- establish rewards for work; and

-- are a critical step toward achieving a convertible ruble.

Two, it is hard to envisage the success of price reform until the ruble's value is stabilized. The ruble overhang -- created by massive deficits financed through printing money -- means that if prices were freed at present, the demand for goods would send prices soaring.

The ruble overhang could be reduced by: selling state-owned assets (apartments, equipment, and land); issuing financial instruments with positive rates of return after inflation; and possibly selling consumer good imports at a substantial markup. The substantial Soviet gold stocks might also be used to back the value of the ruble or government bonds. As major gold producers, the Soviets could use future gold production to regulate the money supply.

It is important that these monetary policies be accompanied by fiscal restraint. Otherwise there would be a new ruble overhang. Targets for spending cuts might be: subsidies to firms, defense spending, and military aid to foreign clients (Cuba, Afghanistan, Ethiopia, Vietnam and Cambodia). Improved production efficiency, especially in the countryside, could also reduce government spending. Higher taxes, in contrast, will hinder the development of business initiative.

Three, microeconomic reforms in industrial organization must accompany market prices and macroeconomic stabilization. Enterprises and cooperatives must have the freedom to compete. Monopolies must end. State controls should not limit the ease of entry and exit of competitors. Instead of planners, market signals should determine resource distribution.

Four, the Supreme Soviet must provide legal guarantees for property rights. The new Soviet property law moves in the right direction, but it is a compromise document that avoids use of the term "private property." On the plus side, it provides the legal foundation for development of small-scale private enterprise, diversifying forms of ownership and granting some additional rights to individuals and foreign investors. It does not, however, allow private ownership of land or the direct hiring of workers, which precludes the development of large-scale private enterprise.

Five, the Soviets must move carefully in substituting tax and regulatory policies for confiscation and production directives. The power to tax remains the power to destroy, and over-regulation can choke off striving enterprises.

Six, the Soviet Union will need to ensure the social welfare of those who cannot fend for themselves in the changed economic environment. At present, social welfare is managed through enterprises and there is no real system to ease adjustments as inefficient firms adjust to meet competition, or even go out of business. Competition is likely to require unemployment insurance and worker retraining programs. There will be a need for a bankruptcy law permitting the restructuring or liquidation of failed enterprises.

These tasks pose a major challenge to perestroika. But even this brief analysis points underscores that the necessary reforms are interrelated. Action on any one element by itself will not suffice. The different measures must act in concert if the new economic system is going to work.

U.S. Policy

For some time, this Administration has made clear that it wants perestroika to succeed. Perestroika can help create a more open society, channel claims for societal resources away from the military to civilian uses, and create institutions with no interest in military adventurism. In short, perestroika can transform the Soviet Union into a cooperative member of the international community.

We have a national interest in the spread of our core values: self-determination, democracy, individual rights and freedoms, economic liberty, market economics, and the peaceful resolution of conflicts. So we welcome the Soviet Union's movement toward accepting these values.

Realism is called for, however, in assessing the actual influence we can have on perestroika. We must avoid the siren song calling for direct aid to Moscow. As President Gorbachev has stated on numerous occasions, the success of Soviet reform depends on the Soviets themselves. It was the discarded view of General Secretary Brezhnev that Western technology, credits, and know-how could produce a Soviet economic turnaround.

In our view, the best approach toward supporting both perestroika and America's interests and values is a creative search for points of mutual advantage in those areas most open to superpower cooperation: making Europe whole and free; resolving regional conflicts; negotiating stability and predictability-enhancing arms control agreements; supporting the rule of law in the Soviet Union; and working together on technical economic cooperation.

Let me focus here on the strictly economic aspects of this search for mutual advantage. We have begun a program of extensive technical cooperation with the Soviets, designed to facilitate the massive task of restructuring their economy. The President presented a list of possible projects to Gorbachev at Malta. Ongoing efforts have included:

-- Chairman of the Council of Economic Advisers Boskin recently visited Moscow to discuss Soviet reforms;

-- in March, the Soviet Finance Minister and Chairman of the State Bank visited Washington for detailed discussions with Treasury Secretary Brady, Federal Reserve Chairman Greenspan, and me;

-- in February a group of Soviet experts spent 10 days traveling around the U.S. under Commerce/SBA auspices to study small business operations;

-- in February another delegation visited New York and Washington under New York Stock Exchange auspices to study financial markets and stock exchange operations;

-- the IRS has offered tax advisory services to the USSR, aimed at establishing efficient tax administration.

-- a group recently visited Moscow to expand cooperation in developing census and economics statistics.

In addition, we are exploring a host of other steps we can take to share our experience across a broad range of sectors. In particular, if the USSR moves ahead with a major reform effort this year, as they have suggested, we might be able to offer perspectives on particular proposals.

At Malta the President presented a series of bilateral commercial initiatives designed to demonstrate our support for perestroika, serve our economic interests and, in the process, help teach the Soviets about the practical workings of market economies. The President proposed the start of negotiations on a trade agreement with a view toward completing them by the June summit. We have had three rounds of negotiations. If the Soviets pass and implement an emigration law in conformance with international standards by the time we have completed an agreement, the President has said he intends to waive the Jackson-Vanik Amendment, paving the way, with the trade agreement, for the extension of most-favored-nation status.

Also at Malta, the President told Gorbachev that once he waives Jackson-Vanik, he will explore with the Congress lifting the various restrictions on USG lending to the USSR. We have also begun negotiations on a bilateral investment treaty, which should take some time to complete, and a revised tax treaty, on which we are making substantial progress. We have agreed in principle to a new long-term grains agreement, which should be ready for summit signature. We are also pursuing negotiations on an expanded civil aviation agreement and a maritime transportation agreement.

Finally, we can continue to challenge Moscow to implement the domestic economic reforms needed for increased international economic interaction. At Malta, the President stated his support for Soviet observer status in the GATT in order to help acquaint the Soviet Union with GATT norms and procedures, and with the market-oriented trading policies on which the GATT is based. The President also supported cooperation with the USSR in the CSCE and the OECD. I am delighted to report that the Soviet Union at the recent CSCE Bonn Economic Conference joined in supporting the final document that included market economic principles. Soviet cooperation with the OECD would be through the recently established Center for European Economies in Transition. We continue to oppose, however, Soviet membership in the IMF or the IBRD because we believe their economy is incompatible with the market norms and transparency required of the members.

Some Conclusions about Soviet Economic Reform

Perestroika and glasnost are President Gorbachev's effort to remake the Soviet Union. That may not have been his aim in 1985, but the failures of the early reform efforts convinced him and his colleagues that change must be far more fundamental. These are practical and determined men, whose aim is not freedom for freedom's sake, but the modernization of the Soviet Union. They are not the heirs of Locke and Montesquieu, but of the great Russian modernizers, like Peter the Great and Alexander II.

The failure to produce economic results has not deterred Gorbachev. As he has shown repeatedly, he uses obstacles to further consolidate his authority. Then he takes steps to press political and economic reforms further. He does not fold; he does not call. He raises the stakes.

Nevertheless, Gorbachev and his allies still must operate as members of a collective leadership with very different notions of what reform means. The development of a Supreme Soviet with some authority has merely extended these conflicting views of the reform process to a larger body. So the decisions are often compromises.

This ad hoc policy development process is a severe handicap when the objective is to overhaul a society's basic attitudes toward economic life. It would be a mistake, however, to conclude that the challenges are necessarily too daunting for perestroika. Over the years, Gorbachev has steadily secured greater power; his new presidential powers represent the latest and most extensive steps in this process. This accumulation of power creates, however, an irony given Gorbachev's claimed interest in opening up the Soviet society and power structure. I would expect it will be important to examine the steps taken up to and during this summer's Party Congress to ascertain the real direction of reforms.

We want perestroika and glasnost to succeed. But we also recognize the limits of our influence. This is an internal evolution whose success depends ultimately on the Soviet people.

Of course, the United States will continue to pursue our national interest. But that interest does not exist in isolation from the events taking place in the Soviet Union and Eastern Europe. Our task is to find points of mutual advantage where both we and the Soviets can gain. This involves full engagement across the span of issues concerning our two countries: regional conflicts, arms control, human rights, transnational relations, and bilateral topics such as economics. At Malta and in the series of ministerials leading up to the spring Summit, we have been doing just that.

Before turning to Central and Eastern Europe, I would like to make several points about the situation in Lithuania.

The people of Lithuania must not be denied their rights. We support the aspirations of the Lithuanian people for self-determination. We have never recognized the forcible incorporation of Lithuania, Latvia, and Estonia. The Supreme Soviet has called the 1939 Molotov-Ribbentrop Pact and its secret protocols illegitimate, effectively making the incorporation illegal.

It's time to engage in a dialogue, and not merely talk about having a dialogue. The Lithuanians want such a dialogue. That's the answer: dialogue, not economic boycotts or threats to invoke Presidential rule.

Our policy toward the Soviet Union is shaped by what's in **our** interest.

It's in our interest to see the countries of Eastern Europe free of Soviet forces and secure from threats that could reverse their revolution.

It's in our interest to see the Soviets destroy 40,000 tanks through a CFE agreement.

It's in our interest to lock-in major reductions in Soviet strategic forces and to create a more stable, predictable and secure relationship that reduces the risk of nuclear war.

It's in our interest to settle regional conflicts in a way that fosters peace and freedom -- as we did in Central America.

And, it's in our interest to see the reform process go forward in the Soviet Union so it will be more committed to internal progress than external expansion.

But some of our bilateral contacts with the USSR may be more directly in their interest than in ours. And those contacts are being put to risk by Soviet actions -- even short of force -- in Lithuania.

Our willingness and ability to take steps that benefit perestroika in the near term is, to be sure, affected by Soviet behavior. Perestroika, glasnost, and democratization cannot be divisible. The reform process won't go forward and succeed if it is applied in some republics and denied in others.

CENTRAL AND EASTERN EUROPE

The Politics of Eastern European Reform

Two months ago in Prague, I noted that the "historic, democratic movements that we are witnessing across Europe... hold great promise for all of us. ...(But) initial impulses for democracy may not be enough. If 1989 was the year of sweeping away, 1990 must become the year of building anew." One challenge confronting the transitional governments of Eastern Europe is organizing and implementing fair and free elections that establish open parliaments with a place for opposition. In Prague I underscored the necessity for the new democracies to respect the rule of law, fundamental individual rights and liberties, and minority rights.

Since that time, free and fair elections have been held in the GDR, Hungary, and in Slovenia, a republic of Yugoslavia. A non-communist, coalition government has been formed in the GDR and a non-communist coalition is expected in Hungary now that it has completed two rounds of balloting for parliamentary seats. Open, freely contested parliamentary elections are scheduled over the next two months in Romania, Czechoslovakia and Bulgaria. Poland will hold local elections for some 50,000 positions on May 27. Election observers from the United States and other CSCE countries will be following the balloting in each country to authenticate the process.

The governments of Eastern Europe, most still transitional, demonstrate clear signs of progress toward democratic government and economies based on the market rather than central planning. Poland's Solidarity-led government has successfully begun a bold economic program which, despite the sacrifice involved, is supported by the people.

In Hungary, a coalition government formed by the Hungarian Democratic Forum will need to maintain and accelerate the economic reform program devised by the transitional government under Premier Nemeth. Among other things, that program slashes the deficit by cutting producer and consumer subsidies, trimming defense expenditures and raising rents and taxes. Parliament will shortly determine how to select the next President--through direct plebiscite or by a vote of the new parliament.

We have seen some progress in the political sphere since my visit in February to Sofia. The current government has agreed to international election observers and set a date for the elections - June 10, with a runoff June 17. Political parties are forming and holding political rallies. However, significant concerns relating to free and fair elections still remain -- including equal access to broadcast and print media by opposition parties, dismissal of opposition activists from state employment, and secret police activities in the democratic process. The National Assembly has passed legislation that permits members of the ethnic Turkish and Bulgarian Muslim minorities to reclaim Muslim names, mosques to reopen and Turkish to be spoken-- despite some opposition by the ethnic Bulgarian majority. The decision by the National Assembly to end the forced assimilation policy of the Zhivkov regime is one example of an important principle I spoke of in my Prague address, that "majority rule must respect minority rights." We encourage Bulgaria's leaders to pursue actively this commitment to minority rights and assure the legislation is effectively implemented throughout the country.

Freedom of expression, religion and travel have been declared and are being increasingly practiced in Romania. Independent political parties are building toward elections scheduled on May 20, although the ruling party continues to control the overwhelming share of media and electoral resources throughout the country. Regrettably, Romania in recent weeks has demonstrated that a newly opened political environment without established democratic institutions and principles can lead to a resurgence of historic ethnic animosities. Ethnic

Hungarians and Romanians have clashed in the streets over the issue of minority rights. We are watching this situation carefully and hope that further violence will be avoided.

My trip to Prague in February confirmed the progress of democratic and economic reform in Czechoslovakia. The "government of understanding" led by Vaclav Havel has announced an ambitious program of political and economic reform to create favorable conditions for elections on June 8. President Havel himself has taken a key role in promoting a dialogue and consultation among Eastern and Central Europeans on a variety of issues of concern to the emerging democracies.

Economic

Successes in the political sphere must be reinforced by successes in the economic. For democracy to succeed in Eastern Europe it must hold out the hope of a better life for the people of this region. Economic vitality in these new emerging democracies is essential to maintaining the stability of Europe.

The countries of Eastern Europe are faced with the daunting task of creating a market while coping with the legacies -- in the form of high external debts, little or no domestic savings, inflation, low worker productivity to name just a few -- of central planning. Each of these countries must determine its own economic policies. We cannot impose a system upon them. However, we stand ready to help -- both in advising them on the policies and in helping them implement them.

A year ago tomorrow, President Bush pledged America's support to Poland in its efforts to transform its political and economic structure. This policy was extended to Hungary late last Spring. With the introduction of the "Eastern European Democracy and Free Market Act of 1990, " the President extended this policy to all of the newly emerging democracies of Eastern Europe.

Our support must be flexible. Each of the countries is going through a similar, but distinct process. For example, although Solidarity and Civic Forum are similar, their histories and the process by which they have overcome the Marxist-Leninist system are distinct. Therefore, our support must have both general approaches to support democracy and the establishment of market economies, and flexibility and distinctions adapted to each individual country.

As I outlined in Prague, we see three stages of support available to these emerging democracies:

First, we are prepared to provide short-term emergency assistance based on need. We will be there to break the fall. But we will do so in a way that does not undercut the revitalization of homegrown solutions. We have already provided such assistance, in the form of food aid, to Poland and Romania.

Second, we are prepared to help these countries make the transition from Stalinist command economies to market system driven by private enterprise. We must appreciate that in these areas the countries of Eastern Europe have embarked on uncharted waters. Therefore, assistance -- both technical and financial -- will be needed.

Third, we must integrate these new market economies into the international economic system. They, too, are eager to end their economic isolation, recognizing that they need discipline as well as the opportunities provided by regional and global financial and economic institutions.

The task before these countries and their peoples is unprecedented. They must create -- almost overnight -- an entirely new economy -- ones based on private enterprise, free competition, and market prices. We have held extensive discussions with the Governments of Poland and Hungary on what types of assistance are needed. We have also begun such discussions with the Government of Czechoslovakia. The European Commission, on behalf of the G-24, has begun such discussions with the other countries of the region. We anticipate responding to some of these needs with the funds we hope will be available next fiscal year.

SEED I

Last year, we joined with the Congress to pass the Support Eastern European Democracy Act of 1989. This Act has given the Administration the resources with which to respond to these historic events. We were able to lead the way in the creation of the Polish stabilization fund. We have launched the Polish and Hungarian enterprise funds -- funds designed to promote entrepreneurial activity in these countries. We have been able to begin providing these countries with limited technical assistance and training.

However, the SEED Act has a major fault. A fault that we believe if left uncorrected will limit U.S. efforts in coming years. The SEED Act was earmarked for a variety of specific projects. Eastern Europe is going through a very dynamic process. We cannot estimate what the needs will be three months from now much less 18 months. For example, the Polish stabilization fund, from conception to creation took three months. We were lucky that the timing was appropriate for the SEED Bill.

This earmarking threatens to deny us the opportunity to respond to the most pressing needs. That is why the Administration, in our new bill, has asked for flexibility. We want to work with the Congress to provide assistance to these countries, but we want to keep bureaucratic requirements to a minimum.

Therefore, I cannot give you a dollar-for-dollar accounting of our plans for FY-1991. I do not have one. I can, however, explain our plans and expectations.

In FY-1991, we plan to provide assistance in four general areas:

- Humanitarian assistance and support for democratic institutions;
- Technical training and technical assistance;
- The environment; and,
- Transitional economic support.

We believe funding keyed to these categories would provide us with the flexibility needed to support the transformation of these societies.

I can also promise that we intend to keep down the level of bureaucracy in our assistance program for Eastern Europe. However, to do so, I need your help. Through the office of the coordinator, Larry Eagleburger, we have reached out to all parts of the U.S. Government. We will use the most appropriate agency to implement programs. But it is not helpful to have you tell us that one agency must be used for this purpose and another agency for that.

We are also reaching out to the private sector. The Commerce Department has established the Eastern European Business Information Center. We have held conferences for non-governmental organizations. We can, and will, do much more.

We must keep in mind that the United States is not alone in this endeavor. Fortunately, the contrary is true. At President Bush's initiative, the Paris Summit asked the European Commission to coordinate Western support for political and economic reform in Poland and Hungary. This resulted in the G-24 effort, which currently includes all the members of the OECD.

The G-24 mechanism has been effective. All in all, G-24 member states have committed over $14 billion in grants, credits, credit guarantees, food aid and technical assistance to Poland and Hungary. In addition, the G-24 member states, including the United States and the EC, have improved Poland's and Hungary's access to markets in the West. The United States wants the G-24 to do even more. We will be working in the G-24 to expand coordination between donors. For example, the EC has joined with us to support the Regional Environment Center in Budapest. We expect to cooperate with the EC on other joint projects in the future.

The European Bank for Reconstruction and Development (EBRD) will be an important part of the Western response to the recent dramatic developments in Central and Eastern Europe. I believe U.S. involvement and leadership are important to demonstrate our political commitment to the reform process in Central and Eastern Europe.

Unlike the World Bank and other existing institutions, the EBRD has a broader purpose than economic development -- to assist the political and economic transformation of these countries. No other international financial institution has the goal of promoting democracy, pluralism and rule of law. The EBRD along with the IFC will concentrate on developing the private sector. Its charter will require that at least 60 percent of resources be devoted to private sector projects. These features set apart the EBRD from other institutions and give it a compelling justification.

We have had serious reservations about the role in the bank initially envisaged for the USSR. We believed from the outset that Soviet borrowing should be strictly limited. Most of the other participating countries agree that the USSR's size and global position make it essential to limit Soviet borrowing. Our concerns on this point have been resolved. The Soviet Union has agreed to a formula which will limit Soviet borrowing to the amount of the USSR's paid-in contribution to the capital of the bank for at least the first three years of operation. Any change in borrowing status will require the concurrence of 75% of the member countries representing at least 85% of the EBRD's voting power.

The U.S. will have ten percent of the bank's capital and be the largest single shareholder to underline the importance we attach to the bank and to our partnership with Western Europe. With an ECU 10 billion capitalization -- equal to about $12 billion at current exchange rates. The U.S. commitment over five years would be about $350 million in paid-in capital and $817 million in callable capital or $233 million annually ($70 million paid-in and $163 million callable).

The OECD also has an important role to play in assisting the countries of Eastern Europe. Last year, the U.S. proposed and the OECD has established a Center for European Economies in Transition. The Center will coordinate activities of the OECD with Eastern European countries and the Soviet Union, including seminars and technical assistance directed at specific sectors or policy areas.

Integration into the World Economy

However, assistance is only part of the solution. Successful economic reform requires private capital and a thriving private sector. As Czechoslovakia's new Finance Minister Vaclav Klaus put it, we don't need old types of cooperation, we need business.

Businesses need market prices and an opportunity to compete. It's up to each government to provide a conducive legal and economic environment to attract private capital, to seel factories to private owners, and to lift the heavy hand of excessive government intervention.

In addition, we in the West must work with these countries so that they may join the various multilateral economic institutions, including the IMF, World Bank and the GATT, as soon as they are prepared to meet the obligations of membership.

We must also seek to remove barriers to trade both bilaterally and in the GATT. In this respect, we have one important measure now pending before this committee. In the "Eastern European Democracy and Free Market Act of 1990," we proposed that Czechoslovakia and the German Democratic Republic be removed from the prohibited list for GSP beneficiaries. We hope that this committee will be able to move expeditiously on this matter.

We also expect to be working with this Committee with regard to Jackson-Vanik waivers and the negotiation of trade agreements. As you are aware, the President has waived Jackson-Vanik for Czechoslovakia and Ambassador Hills signed the commercial agreement on April 12. We continue to review the situation concerning Jackson-Vanik waivers and trade agreements for Bulgaria and Romania.

COCOM

We are also working with our COCOM allies to relax barriers to trade in certain areas, particularly telecommunications, machine tools, and computers. We are seeking assurances that COCOM-restricted technology will not be transferred without approval to third parties. Discussions on high technology trade with Poland are going on as we speak.

The EC Role

The EC must be commended on the role that it has played in this endeavor. In its coordinating role, its financial contribution, and in the removal of barriers to trade, the EC has set an example for all of the G-24 members. It has acted quickly and generously to meet emergency food needs, complementing similar steps by the U.S.

Bonn CSCE

The CSCE Conference on Economic Cooperation in Europe, just concluded in Bonn, has produced a final document which we feel meets our substantive objectives for the conference: it sets forth the overarching political and economic goals for long-term economic cooperation between East and West. As a result of Bonn, the CSCE process now provides us with a basis for broad cooperation with the countries of Eastern Europe in overcoming the many difficult challenges in making the transition from a command system to a free-market economy. Followup activities to the Bonn Conference will ensure that Basket II of the Helsinki Agreement receives the impetus and sustained attention it deserves.

COUNTRY-BY COUNTRY BREAKDOWN

Poland: The Mazowiecki Government has continued to set the pace in both the political and economic transformation of its society. The democratic system that was fashioned out of a compromise with the communists has proved adaptable. The Government's economic plan won the support of the IMF and has achieved tremendous success at driving inflation out of the economy, lowering interest rates, and stabilizing the currency -- at a cost, however, in terms of unemployment and the level of economic activity. U.S. support is at its highest in

Poland. We played a leading role in putting together the Stabilization Fund, and our Enterprise Fund will do much toward supporting the developing Polish private sector. We have regular discussions with the government on its assistance needs.

Poland also set the pace in terms of the recent Business and Economic Treaty we negotiated. This treaty will provide U.S. businessmen with important guarantees for repatriation of profits and\arbitration rights. We expect the Polish agreement to serve as a model for future agreements.

Hungary: We also expect to work closely with the new Hungarian Government. This new government will benefit from the reforms undertaken by the Nemeth regime. We expect to work with the new government on determining its assistance priorities. Already we're supporting Hungary's private sector through the Enterprise Fund, and the President's proposal for a Budapest Regional Environmental Center should do much toward helping the Hungarians and others combat their dire environmental problems. We will also reactivate our proposal for a bilateral investment treaty.

Czechoslovakia: On April 12, Ambassador Hills signed the trade/commercial agreement with the Government of Czechoslovakia. The agreement grants Czechoslovakia MFN consistent with the requirements of the Jackson-Vanik amendment. Czechoslovakia's application for re-admission in the IMF/World Bank is currently under review. A bilateral investment treaty is currently under negotiation.

Yugoslavia: We recently proposed negotiation of a bilateral investment treaty. We are awaiting their response.

Romania: Waiver of the provisions of the Jackson-Vanik Amendment will be based on improvements in the overall human-rights situation in Romania and especially on the holding of free and fair elections. There is already a valid bilateral trade agreement between Romania and the United States, which is due for renewal this year. We are now considering if we should allow this agreement to role over automatically at mid-year. If we so decide, we will pursue a bilateral investment treaty, into which we will seek to incorporate provisions on business facilitation that are now normally included in our trade agreements.

Bulgaria: The Bulgarian Government has also given us the assurances required under the Jackson-Vanik amendment concerning free emigration. Improvement in trade with Bulgaria will be based on free and fair elections and on the overall human rights situation in the country.

CONCLUSION

It is extremely difficult to summarize the state of reform in the Soviet Union and Central and Eastern Europe. While all of the countries I've discussed must cope with the terrible legacy left by Stalinist central-planning, each country occupies a unique position in dealing with that legacy. But each -- so far -- has shown some willingness in overcoming that legacy and moving closer toward market-based systems, though the success of their efforts will be far from assured for years.

What is clear is the vital need for the United States to stand alongside the reformers as they struggle to build the institutions of economic freedom Standing with them is consistent with both our values and our interests. It is consistent with our values because free markets not only allow for but also encourage individual freedom and initiative -- hallmarks of a vigorous democracy. Free markets are also the surest guarantor of economic prosperity -- prosperity which will underpin and fuel the newly emerging democracies in Central and Eastern Europe.

Yet the success of the reforms is also consistent with our interests. For years, we in the West have been burdened by the task of containing a Soviet Union bent on external aggression and illegitimate domination of the peoples of Eastern Europe. Now those peoples are finding their freedom, and the new thinkers of the Soviet Union are encouraging internal reconstruction, instead of external adventurism. Over the long run, this can only be for the good. Beyond containment does lie democracy -- and, hand in hand, economic freedom. This truly can be the success story of the 1990s.

Mr. Chairman, this Administration is pledged to play a positive role in supporting reform in the Soviet Union and Central and Eastern Europe. To do so, we need to have the maximum flexibility possible to cope with continually changing circumstances. Together, we can do our part to make the revolutions of 1989 democratic realities well into the next century.

Thank you.

Chairman **Rostenkowski**. Thank you, Mr. Secretary.

I would rate that statement as A-1. Mr. Secretary, I think that you and I and most of the members of this committee would agree that even with Eastern Europe and the Iron Curtain melting and the Berlin Wall coming down or crumbling, nobody thought that we would be at this point with respect to the democratization of Eastern Europe.

One naturally becomes concerned, as I am sure you are, of the polls that were taken just the other day of how the American people are viewing Lithuania. By a vast majority of people polled, it was suggested that the United States slow down or mind our own business, not get involved.

How do you account for that, Mr. Secretary?

Secretary **Baker**. How do I account for the polls that suggest that we should somehow not get involved in the question of the Baltics?

Chairman **Rostenkowski**. Yes, sir.

Secretary **Baker**. Well, I don't know, Mr. Chairman. I suppose that some of it is a recognition on the part of the American people that we have a lot of interests at stake here that are very important to the United States of America as I just mentioned.

I mentioned a number of those in my oral remarks. Arms control is one. The solution of regional conflicts is one. Seeing the Soviet Union continue to move toward democratization openness politically, and seeing it move, if at all possible, toward the establishment of a free market economic system.

I think it is a recognition probably on the part of the majority of American people of those facts that accounts for those poll results.

Chairman **Rostenkowski**. Mr. Secretary, in February, I wrote President Bush, expressing my strong conviction that trade agreements reached under the authority of title IV of the Trade Act of 1974 be submitted to the Congress for its approval in spite of constitutional questions surrounding certain provisions of the law.

As you undoubtedly know, the House has passed, and the Senate is now considering legislation which would correct any constitutional infirmities in the law.

U.S. Trade Representative Carla Hills last week signed a trade agreement with Czechoslovakia and the President hopes to sign a similar agreement with the Soviet Union in late May.

I have not received any substantive reply to my February letter from the administration. Would you be kind enough to tell the committee what is the position of the administration with respect to the submission to the Congress of trade agreements negotiated with nonmarket economy countries?

Secretary **Baker**. Mr. Chairman, it is my understanding that we have no objection to working closely with the Congress and, quite frankly, would support efforts to fix the constitutional problems that exist in current law.

I don't think the executive branch has taken the position that somehow the law should not be amended to fix the constitutional problems so that we would be free to negotiate these agreements without close consultation with Congress.

Chairman **Rostenkowski**. Well, Mr. Secretary, I am hoping that the Senate will conclude its deliberations and that we will get that behind us. But I just wanted to know in the interim if there was any disagreement.

Mr. Gibbons will inquire.

Mr. GIBBONS. First of all, Mr. Secretary, I applaud your statement. I think it was very statesmanlike and very forward looking. And I want to join you in the search for mutual advantage. I think that is a fine theme that we should emphasize in our negotiations with the U.S.S.R.

Let me follow up on Mr. Rostenkowski's question about Jackson-Vanik, assuming that it does have constitutional problems as it now stands.

I assume that what you said when you responded to his question is that the administration will follow the letter and the spirit of Jackson-Vanik as far as it can before a trade agreement with Russia is agreed to. Am I correct?

Secretary BAKER. That's correct. And we have been trying to do that, Mr. Gibbons.

Mr. GIBBONS. Let me raise some other issues that I hope will be considered at the summit. I wish you success at the summit, and I wish you success in the arms agreement that is being negotiated.

I was home during the Easter recess, and I got many questions from constituents about Cuba. We are making great progress with the Russians and some of their problems, given the fact that they have serious internal problems within Russia.

But why are we supporting Russia and helping Russia at the same time Russia still seems to be spewing forth a large amount of money into Cuba? Why should we help them? Will that be raised in the summit?

Secretary BAKER. It is raised every time we sit down with the Soviets, Mr. Gibbons. And in fact when I was last in Moscow in February, I posed the question to the International Affairs Committee of the Supreme Soviet when I testified before them, the first time, I might say, that any American official has testified before the Supreme Soviet. And my question was if you really are interested in transforming your economy and curing the problems that you are experiencing of shortages of consumer goods and soaps and things like that, why are you spending some $13 to $15 billion a year in continuing to support regimes around the world such as Cuba, Angola, Afghanistan, and so forth?

I really think that that issue is becoming one of much greater prominence in the internal deliberations that are going on within the Soviet Union. And I think that ultimately, as we have seen in some other parts of the world, I would hope and believe that we will begin to see a reduction in the economic and military assistance, particularly that is afforded to Cuba.

We began to see some of that in Nicaragua, Mr. Gibbons, before the successful elections down there that were won by UNO.

Mr. GIBBONS. Mr. Secretary, because of my age, I have had the opportunity to live through two great wars, a hot war and a cold war. We seem to have won both of them, although I am not real sure about the cold war yet. I think we have won it.

What really concerns me as we move into the 21st century is winning the peace. I realize that that is a highly idealistic and sort of vague goal, but it is my goal. And what concerns me is I don't think that we and our Government are really gearing up to win that peace.

As I look at these countries that have been deprived of freedom because of history for so long, I see in them a yearning for peace and a yearning for freedom that we have been struggling with for 300 years on this continent. But they just do not have the background or experience. The people in their countries, if they ever experienced peace and freedom, are dead, gone; and those remaining need help. They need hands on help from a broad base of people in our society who could perhaps help them.

Does the administration have any plans for how we can mobilize to win this peace, or how we can mobilize the American free movement to win this peace?

Secretary **Baker**. Well, I think we are mobilizing to win it, Mr. Gibbons.

Let me give you one example. Last year, at the economic summit in Paris, the President of the United States suggested that we get together in a multilateral effort to assist Poland and Hungary economically. And we have, as a consequence of that, pulled together some $13.5 billion in assistance, support, credits of one kind or another; $23 billion if you want to talk about rescheduling some of the indebtedness of those two countries.

We have legislation pending on the Hill now for additional moneys for Eastern Europe. We have legislation pending on the Hill now for economic support funds and other economic type assistance for the newly won democracies in Panama and Nicaragua. I think your question is a very appropriate one because we have, in the past, failed to win the peace. I think that the job before us is, as you have described it, to win the peace.

But I really would suggest to you that I think we are mobilizing as a government, and I just don't mean executive, I mean executive and legislative branches of this Government are mobilizing in order to do just that, both in this hemisphere and in Eastern Europe.

Mr. **Gibbons**. As I close, let me recommend to you a good idea that I stole from Chairman Rostenkowski one day in one of these hearings.

He suggested the formation of a freedom corps. My time has expired but I will talk to you later about it.

Secretary **Baker**. Well, it is an idea we have been giving some thought to, Mr. Gibbons, and we are continuing to do that because it is a very good idea. We have a little bit of a different wrinkle.

Chairman **Rostenkowski**. Mr. Archer.

Mr. **Archer**. Thank you, Mr. Chairman.

I might follow up just a little bit on the topics that have already been discussed, Mr. Secretary.

Inasmuch as the U.S.S.R. does still maintain an aid program of somewhere in the vicinity of $15 to $16 billion in the aggregate supporting what could be called continued Communist objectives in the world, in the countries that you have already mentioned, should we not consider treating them a little bit differently insofar as granting MFN than the other Eastern European nations which have asserted their own independence from the hegemony of Moscow and are charting their own course?

And, in addition, I might add that not only is the Soviet Union continuing to provide this large amount of external aid, but we are also, at least in the period from 1987 to 1989, subsidizing our own food exports to the Soviet Union in the amount of $481 million. And I wonder if you consider that that is a good policy in these times?

Secretary **Baker**. Mr. Archer, I won't argue with you with respect to the principle of subsidized food exports. I would only point out to you that that is something the United States of America has been doing for many, many years, and we have been doing it at times because some in this country think it is very much in our interest in terms of exporting some of the farm surplus that we generate in the United States, we have been doing that for a long time. We have been doing that during periods of time when the Soviet Union's behavior was far worse than the things that we complain about today. We were doing it when the cold war was at its height, and we were doing it when we were not seeing the kind of progress toward reform and freedom in Eastern Europe, the kind of progress on arms control and that sort of thing that we are seeing today.

So I don't stand before you to defend the principle of that, but I just point out to you that the situation today is much better than it has been in the past when we followed that same policy.

With respect to treating them differently, I think we do treat them a little differently than we do the countries of Eastern and central Europe in the sense that we are insisting with respect to the Soviet Union that there be a legal codification of their immigration policies, something more than just the practice of permitting freer immigration. And I do think we have to admit to ourselves that the Soviet Union has shaped up considerably with respect to their more liberal immigration policies.

But we are requiring, before we consider MFN, as you know, that the Soviet Union codify their immigration policies.

Mr. **Archer**. So the only distinction that you would see relative to granting MFN would be the question of the requirements of Jackson-Vanik then?

Secretary **Baker**. Well, I think we are looking more and more, Mr. Archer, at human rights issues other than just free immigration. Even though the law talks about free immigration with respect to Jackson-Vanik, we have been looking at other issues. But we have been doing that with respect to other countries as well. So I don't think that there is a distinction between Eastern Europe and the Soviet Union in that respect.

Mr. **Archer**. Following up a little bit on the question of Lithuania, as rapidly as developments are occurring in the Baltic countries with the assertions of independence, should we treat these countries differently for trade policy purposes than the Soviet Union, or should their products be lumped together and their services in the other areas of commercial intercourse be lumped together in the same basket with the Soviet Union?

Secretary **Baker**. Well, right now, Mr. Archer, it is pretty difficult to treat them differently, because of the policy that we have and have followed for many, many years.

I think the real answer to that question will depend upon subsequent events. I have already said that we think that the aspirations of the Baltic peoples should at some time be realized. That is our policy and our position, and we have never recognized their forcible incorporation in the Soviet Union.

When those aspirations are realized, when there is self-determination, then I think we have a totally different situation. It is pretty hard today to identify with any great degree of specificity, as I understand it, the products that come from one particular republic or another.

Mr. ARCHER. Mr. Secretary, I thank you very much for your direct and forthright responses to our questions. And I appreciate your coming before our committee.

Chairman ROSTENKOWSKI. Mr. Pickle will inquire.

Mr. PICKLE. Good morning, Mr. Secretary.

Secretary BAKER. Hello, Mr. Pickle.

Mr. PICKLE. Well, I join with my colleagues in commending you for a good statement. At the same time, Mr. Secretary, I tried to read through it hurriedly, and I have listened to you and I have listened to you, and I keep asking myself, now, what did he say?

I am trying to find out in my own mind—have we got a definite policy on our trade with these countries? I guess we have to say we are dealing in generalities, and that is about all you can do at this point.

Secretary BAKER. Did you say with each country or with these countries?

Mr. PICKLE. With these countries, with these emerging democracies.

I guess the only way we will find that out is by specific question or specific examples, will you approve the sale of these goods or not?

But what are you going to do in countries that are merging? I notice on page 35 you said that you are prepared to give them short-term emergency assistance based on need. You are going to help them go from a Stalinist command economy to a market system driven by enterprise, and that you are going to integrate these new markets in a national economic system.

Now, what are you going to do in a case of East Germany? Are you going to try to reach an agreement with them before there is unification?

Secretary BAKER. Well, the German Democratic Republic is a special case, Mr. Pickle, because of unification. We think that we ought to work on expanding our economic relations with the GDR pending unification but recognizing that unification is going to proceed more rapidly than anybody originally anticipated.

So I think that we ought to continue. We have established a dialog with them. We ought to continue that dialog as unification progresses.

Let me suggest to you that we've taken specific actions with respect to many of these countries that would, I think, delineate for you with particularity what I meant by the statements you read from my statement.

We have a business and economic treaty with Poland. We have opened Eximbank for short-term guarantees in Poland. OPIC is sending a team in mid-May. We are doing much the same thing with Hungary. Eximbank is open for business there. We have got an OPIC investment mission scheduled for the end of this month. Hungary has had MFN and a trade agreement with us since 1978. We are moving on MFN for Czechoslovakia. Ex-Im is open for business now with them. We are doing some of the same things with Yugoslavia. We are considering doing these things for Bulgaria and Romania.

I stopped off in those two countries on my way back from the Soviet Union recently and made the point that what we are really waiting on, as I indicated in my opening remarks, was that they follow through on their commitment to conduct free, fair, and open elections. Once we see that, then I think we can begin to move in some of these areas with those two countries.

Mr. **Pickle**. Well, you are saying that you might consider MFN for a lot of those countries based on certain developments. And that is about as far as you can go, I guess.

Secretary **Baker**. You want to talk about MFN? Well, a lot of them now have it, of course.

Mr. **Pickle**. What are you going to do for Romania?

Secretary **Baker**. Well, let's wait. Let's see if Romania follows through on their commitment to hold a free and fair election. Let's see if they give the opposition groups in Romania equal access to the media that the Government will have. Let's see if the secret police in Romania are in fact eliminated or dismantled.

Those are the kinds of things we are waiting on in Romania and Bulgaria.

Mr. **Pickle**. Well, Mr. Secretary, I am not asking my questions in a critical sense, but it seems to me that you are telling us that we are going to watch it, that they have got to help themselves, that we have got to give them technical assistance, nuts and bolts, and we have got to try to advance them temporary MFN if they will do certain things.

We are on a kind of a time gap though because if we don't establish pretty definite policies as soon as we can, then the Soviets are going to be trading and they will be there ahead of us. And so the time is closing in on us, and I just think we should act as soon as we can.

But it seems a lot of gaps have got to be closed and they have got to be closed pretty quick.

Secretary **Baker**. Mr. Pickle, these elections in Eastern Europe are all scheduled for dates that run between now and the end of June or the first part of July. We will know within that timeframe whether their commitment to democracy and freedom is just rhetorical or whether it is real. If it is real, we think we ought to move, and plan to move.

We have already done some things on the humanitarian side to help them along until we get to that point. We have done $80 million for instance in humanitarian food assistance for Romania.

So it is only MFN that's waiting, that really waits on the test of validity with respect to their statements about democratization and freedom.

Mr. **Pickle**. Thank you, Mr. Secretary.

Chairman **Rostenkowski**. Mr. Rangel will inquire.

Mr. **Rangel**. Thank you, Mr. Chairman.

Mr. Secretary, my Select Narcotics Committee has just returned from Europe and Africa, and I could not have felt more proud as an American than to hear the compliments that were received for you and the President in the leadership that you are providing in Eastern Europe, recognizing it is a sensitive and delicate situation to be critical of Mr. Gorbachev.

We see him holding countries hostage and oppressing its Jewish citizens and, at the same time, to make certain that you are supportive of the reforms that are taking place so that soon, we hope, many other nations will be joining the family of democracies. We know it is difficult and we think that you are doing a good job.

The question I have is how do we do it all? It is clear to me that the administration is and should be committed to peace in the Middle East. We have made economic and military commitments to Israel. We are committed to fairness and equity, to the legitimate claims of the Palestinians. We know that in Africa, we have many, many people oppressed by dictators, some of whom we support. But still we are committed to a fight for economic development and to eliminate poverty and famine in these countries.

I have never felt more proud of our President than the leadership that he and you provided in Cartagena where you sat with leaders in South American countries to fight against these vicious drug lords. But even there you walked away leaving commitments for economic and military assistance to develop substitute crops and to build up these economies.

In Central America, obviously you have bills and requests for more assistance with these countries. And it seems as though America is on the right side. We are promising to give assistance, and it is being appreciated by democracies around the world that we are players, and more and more people are coming here asking us for support.

Of course, they come to America where the poverty has increased, the number of hardcore addicts have exploded. We are dealing with the homeless, the jobless, and the hopeless. They are on our streets. The wounded are crowding our emergency wards. and I guess we are trying to do something about that.

Where is the plan? Where is the budget? Where do we get the money, and how do we not let down our friends who are looking to us, not only for leadership, but for economic support.

Secretary **Baker**. Well, Mr. Rangel, let me suggest to you some actions that I think we could take that would move us in the direction that you just suggested we go.

First of all, we ought to move the President's request for Panama, Nicaragua—the supplemental that he asked for by the 5th of April that is still up here on the Hill. That would be one major step we could take to support freedom and democracy.

Another would be to—following on to the Cartagena Summit that you just mentioned—look at what we can do for the Andean nations of South America and the small nations in the Caribbean that have joined with us in the war on drugs. That is something that you are very, very familiar with and something that is extraordinarily important to the United States and becoming more and more an integral part of our foreign policy, as I think you would now agree with me.

What can we do for those Andean nations and those Caribbean countries? We can stop protecting against their products. We can extend the Caribbean Basin Initiative and open it up just a little bit to apparel, textiles, footwear, something that they can produce that we can buy. All they are really asking for is access to our markets and we will not let them have it.

And I am not faulting any committee, or anybody here or anybody on the Senate side or anybody else, it is just a fact of life. We cannot get it. And that would do more for your war on drugs, if I may say so, than almost anything else we could do, I think.

We have got legislation pending, as well, for additional measures with respect to Eastern Europe. I think we ought to do that. I have already mentioned what we have been able to do through multilateral negotiations with respect to Poland and Hungary. I think the potential is there to do the same thing with respect to some of the other countries of Eastern Europe. I think the potential is there frankly to do it with respect to some of the emerging democracies in Latin America.

Mr. RANGEL. Do you think, Mr. Secretary, that we can do all of these things domestically and fulfill our foreign policy commitments without increasing taxes?

Secretary BAKER. Yes.

Mr. RANGEL. And are you prepared to assist this committee in getting the CBI bill through the Senate and help it reach the President's desk, because we are having difficulty on that side, as you know.

Secretary BAKER. Yes, I have been trying to do that, Mr. Rangel. I have made personal calls to some of the jurisdictional committee members and others, and so far, I am sorry to report without a lot of success.

Mr. RANGEL. Well, I hope you can send to me this overall foreign policy and domestic plan, because it is ambitious and I want to be among the first to support it as long as it does not exclude domestic commitments.

Secretary BAKER. I do not participate in budget summits any more, Mr. Rangel, but I would be glad to engage with you on the issue.

Mr. RANGEL. All I need are the numbers, Mr. Secretary. We will work with that when we get the money.

Chairman ROSTENKOWSKI. Mr. Frenzel will inquire.

Mr. FRENZEL. Thank you, Mr. Chairman, Mr. Secretary.

Mr. Secretary, thank you for coming back to meet with this committee. We are always glad to have you.

Your statement lays out, I think, the principle of the U.S. agenda and priorities and I think most members of the committee would agree with you that it is a good one.

Now, this committee has as one of its jurisdictions that of trade and so we are very interested in developing more. And we have seen the internationalization of markets. At the same time, we have seen the march toward democracy in a number of what you have called emerging democracies.

We are going to be giving MFN to, and have already given MFN to most of central Europe and if things go well, perhaps to the U.S.S.R., as well.

That is, of course, only a tiny step in the development of relations between us and them. There remains a number of barriers, the most formidable of which is the fact that those countries are working controlled currencies, although some of them have made good progress in that regard, too.

There is another internal burden which is self-constructed by us, called the Export Administration Act. This act inhibits shipments of U.S. goods to these countries. At the moment, the United States is working with its COCOM allies to try to—I am told—ease the strictures of EAA. But in the meantime, it is committed to extending the EAA under its current terms, which American exporters and some American security analysts believe are much too strict.

Can you give us any help as to where we may be going with easing those restrictions so that these countries may be able to buy such things as process controls and items that they need to regenerate their reproductive capability, but cannot buy under the current rules?

Secretary **Baker**. Mr. Frenzel, first let me say that the administration is fully committed to adapting COCOM to the changing East-West strategic environment.

You probably know we had an interim proposal that we discussed with our allies at a meeting in February. We expect to make a more comprehensive proposal that calls for greater modernization and more of a shortening of the control list, at the next COCOM meeting which is coming up—at the next high-level meeting that is coming up in June.

We are in the process of a review now to pull together the elements of that proposal. I expect that review will be finished shortly and I do believe that soon you will see fewer fences—higher fences around fewer products, which of course is the objective we are seeking to achieve. We want to do it, of course, in conjunction with our allies. We want to make sure they are on board, because it does not do us any good to have constraints that they find it impossible to observe.

I think that we are making progress on coming up with a core list of products and I think we are moving in the direction that I think you would probably encourage us to move.

Mr. **Frenzel**. Well, that is welcome news, Mr. Secretary.

Most of the COCOM allies that I have talked to have felt that we have been the foot-dragger and that they would like to proceed. And, in fact, in some fiber optic sales that have been proposed, our allies indicate their willingness to make sales where we have been unwilling to authorize them on this side of the Atlantic.

And so, I hope that those things are being worked through and that our negotiators are taking them into account.

Secretary **Baker**. We are doing that. And I am familiar with the discussions we have had with our allies and I, again, I would only say that I think when this high-level meeting takes place in June, you will see that the administration has moved substantially in the direction you want us to go.

Mr. **Frenzel**. Fine. Another thing I mentioned was the difficulties of trading with controlled currencies. And I assume that you are pressing these Eastern European countries and the U.S.S.R. to move as swiftly as they can toward decontrol.

Secretary **Baker**. It is essential to the establishment of a free-market economy, as I know I do not need to tell any member of this committee, Mr. Frenzel.

And we talk about it all the time. It is going to be perhaps a bit easier for some of these countries than it will be for others. Some of these countries have a past history of free market economic experience. Others, for instance, the Soviet Union, do not. I mean it is a lot tougher to turn around a centrally planned economy that has been that way for 70 years, than perhaps it is to turn one around that has been that way for 35 or 40 years.

I think they all understand that ultimately they have got to find a way to get to a freely convertible currency. There are various impediments to their doing that depending on which country you are talking about, with the greatest impediments existing in the Soviet Union.

Mr. **Frenzel**. Thank you, very much, Mr. Secretary, I appreciate your statement.

Chairman **Rostenkowski**. Mr. Downey will inquire.

Mr. **Downey**. Thank you, Mr. Chairman.

Mr. Secretary, I think you are at a fulcrum point of history and I think you are really in a position and have been doing it of establishing, for the first time since the end of World War II, a bipartisan foreign policy vis-a-vis the Soviet Union.

And I, personally, want to congratulate you for your statement and for your handling of what has happened in Lithuania. I think it is exactly correct.

And I would tell you to resist those in this country, and I am afraid probably still in the Congress, who look at Mikhail Gorbachev and see a Joseph Stalin dressed in sheep's clothing, and would love an excuse to jump-start the cold war.

I do not want to see that happen. I do not think you want to see that happen. I know that President Bush does not want to see it happen. And I think that the measured response that you have given us to date is going to prove in the long sweep of history to be the correct one.

I want to ask you specifically about your last, very last statement where you said, "the reform process will not go forward and succeed, if it is applied in some republics and denied in others."

Clearly, the Baltic States represent——

Secretary **Baker**. I said will not succeed if it is applied in some.

Mr. **Downey**. And succeed if it is applied in some republics and denied in others.

Secretary **Baker**. Yes.

Mr. **Downey**. I am sorry.

The Baltic States are clearly a separate case because of their involuntary incorporation into the Soviet empire in 1940—though I guess some of the incorporations of some of the republics probably that occurred in the 1920's were not consensus ventures.

How will we look at the entire issue of internal upheaval in the Soviet Union when we are trying to set out our trade concerns? Assuming that Gorbachev deals with this in a less than violent manner and he does not go ahead with economic sanctions, how are we to assess whether or not the Moldavians should be separate or the Georgians, or the Azerbaijanis. And are we going to have to react to every twist and turn and fit and start inside the Soviet Union when it comes to our trading relations?

Secretary **Baker**. Well, it seems to me that you have correctly stated the unique situation that the Baltic Republics represent, at least insofar as the policy positions of the United States are concerned.

There is a special juridical status there deriving from their forcible incorporation and from our long-established policy of not recognizing that incorporation. The same thing is not true with respect to some of the other republics that you mentioned. And we have, in fact, recognized the boundaries of the Soviet Union as such since 1933.

Mr. **Downey**. Could you speculate with us for a minute about what risks Gorbachev runs by talking tough and acting mildly in the situation of Lithuania? He has promised economic sanctions. He has his own internal problems. And now, he is backing away from them.

How do you assess what that does to him inside the Soviet Union and for the future of perestroika, as it is evolving internally?

Secretary **Baker**. Mr. Downey, I do not think it is my place to judge what that might or might not do to him inside the Soviet Union. I think my job and our job, quite frankly, is to make certain that the message is clear and concise and unambiguous from the United States of America.

And I believe we have sent a clear and unambiguous message. We have made it very clear that we think this matter has to be resolved peacefully through negotiations or dialog. That it cannot be resolved through force or coercion and that if the latter course is adopted that we would have no other choice but to consider what would constitute appropriate responses on the part of the United States.

I do not think it serves a useful purpose for us to speculate in advance on a hypothetical about what those responses should be, and we have refrained from doing that. It is very difficult to, I think, to see perhaps some of the commercial aspects of our relationship surviving the use of force or coercion. And I think I made that clear in my opening remarks this morning.

Mr. **Downey**. Mr. Secretary, we would then view, if Gorbachev backed away from the use of economic sanctions in Lithuania as a positive development and not as an indication of weakness or timidity on his part.

Secretary **Baker**. Well, what we have been arguing for all along, Mr. Downey, is to resolve this matter through dialog. And anything that would move us in the direction of resolving it through dialog would be a very positive development as far as we are concerned.

And I think that message has been received loud and clear by the Soviet leadership. We have made the point to them directly. And we have made the point to them, as well, indirectly.

Mr. **Downey**. Thank you, Mr. Secretary.

Chairman **Rostenkowski**. Mr. Pease will inquire.

Mr. **Pease**. Thank you, Mr. Chairman and Mr. Secretary.

It is beginning to sound like a broken record, but I, too, would like to commend you for what I consider to be a splendid statement that you made initially.

I especially appreciated your stress on our policy being governed by what is in the interest of the United States, but also stressing that there are many areas that are mutually advantageous to the U.S.S.R. and the United States that we can follow.

The Jackson-Vanik statute requires that a waiver of the law's freedom of immigration requirements be issued before a trade agreement may be concluded. Could you tell us what you know about the status of Soviet efforts to codify the freedom of immigration law? And also what the administration plans to do with respect to a waiver and a trade agreement if the Soviet Union has not enacted and implemented such a law by the time of the summit at the end of May?

Secretary **Baker**. Mr. Pease, we have made it very clear to the Soviets beginning in Malta, that while the President would be inclined to recommend a waiver, that depended on two things: The conclusion of a commercial agreement satisfactory to the United States; and the enactment of or the codification of the Soviet Union's freer immigration policies.

You asked me initially what the status of the latter was, and the status of the latter, as I understand it, is that the Supreme Soviet is to consider this—I believe on second reading—on the 22d of May.

Mr. **Pease**. Is the second reading the final reading or do they have to have three?

Secretary **Baker**. I think it is. Yes.

Mr. **Pease**. Can you tell us what progress is being made on a trade agreement which would be the second requirement for a waiver?

Secretary **Baker**. There have been, I think, a couple of sessions, negotiating sessions, on a trade agreement. This, of course, is handled by the Special Trade Representative's Office. One of the hangups now, as I understand it Mr. Pease, is that we are seeking greater intellectual property rights protection than the Soviets have so far agreed to.

I think that is one of the main problems. But there is another negotiating session scheduled some time in the very near future, within a matter of days or weeks.

Mr. **Pease**. Turning to the nations of Eastern Europe, I think we are all very encouraged by what has happened there, by what is happening there, and very hopeful, but at the same time a little apprehensive.

Could you look at the next year or 5 years in Eastern Europe and tell us what your concerns might be about the fragmentation of government that could occur with this new experiment in democracy? For example, there are supposed to be 65 parties in Czechoslovakia and also what you see in relation to a resurgence of ethnic conflicts within those countries of Eastern Europe?

I think of the ethnic minority, or Hungarian minority in Rumania, for example, or the original artificiality of putting Czechoslovakia together; how concerned should we be about the inability of new democratically elected governments to function effectively?

And whether that would be exacerbated by ethnic differences that would be coming again to the fore after many, many years of being relatively quiescent?

Secretary **Baker**. That is a very important question, I think Mr. Pease. And, of course, that has been the source of much of the instability that we have seen in the past in Europe. Unfortunately as we move to greater freedom of expression, greater opportunities for self-determination, there has, and I think will continue to be, a resurgence of nationalism, a resurgence of ethnic concerns and interests.

And that, I think, is perhaps the biggest challenge to peace. And Mr. Gibbons said it is important to win the peace and it is important to win the peace. And I think one of the biggest challenges we face in winning the peace is finding a way to deal effectively with the resurgence of nationalism and ethnic rivalries that are bound to occur.

One way to make certain—one way to help, at least, in dealing with it is to see the development and the emergence of viable economic systems; economic systems that can put goods on the table for the people who are embracing democracy.

And they are going to embrace democracy as long as it succeeds in the manner in which we know it can succeed but it is going to be tough to sustain it if we are not able to see—if those economies cannot succeed. And that is why it is so important that we do what we can to assist the emergence of free-market economies in these countries.

It is also important that we maintain adequate security guarantees. This is primarily an economic committee and an economic hearing, but we ought not to lose sight of the fact that it is important that we maintain—in order to win the peace—adequate security guarantees.

There is a lot of debate now about the unification of Germany and it is the strongly held view of the United States that the unified Germany must remain a member of NATO and that that fact and the presence of American troops in Europe is indeed a force for stability.

All of the nations of the West agree with that, and interestingly enough, many of the nations of the Warsaw Pact and central and Eastern Europe likewise agree. So it is important that we maintain that security apparatus.

It is also important that we look at the potential for greater European cooperation—cooperation among Europeans and between Europeans and North Americans, United States and Canada, through the CSCE process; which right now is only a process, but which as you know, has a human rights basket, an economic basket, and a security basket. And that institution, I think, will also, or that process will become important in the question that you raised having to do with maintaining the peace against emerging nationalism and ethnic rivalry.

Mr. **Pease**. Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mrs. Kennelly will inquire.

Mrs. **Kennelly**. Thank you, Mr. Chairman, Mr. Secretary.

Mr. Baker, I was interested in your discussion on COCOM with Mr. Rangel, and then your additional remarks about East and

West Germany, the fact that trucks now can go back and forth and are not inspected as fully.

If, and when, we get a new COCOM list, Mr. Baker, can we expect this list to really address the level of technology rather than items? Are we going to get sophisticated? We have waited so long for a new list. Do you think that we will be able to examine this in the light of the changes in 1990?

Secretary **Baker**. Do I think it will be a change in our procedures that give effect to the rather remarkable changes that have taken place in Europe?

Mrs. **Kennelly**. Well, now we list items. Would it not be better to list technology or not? Is that asking too much? It has taken so long to get the list to begin with, maybe now is a time to do something dramatic.

Secretary **Baker**. You know, I am not enough of an expert on that to answer that, Mrs. Kennelly. I do not know whether——

Mrs. **Kennelly**. Certainly, sir, but I know there is fear that the COCOM is really going to disintegrate and it is not going to be important any more because these borders are open. And, yet, it is important to us if, in fact, we are going to be allowed to sell machine tools.

And I just wonder if this is not a time to be more openminded?

Secretary **Baker**. Well, I am not going to exclude the possibility that in streamlining the list and in revising our procedures along the lines I explained to Mr. Frenzel, that they might decide to exempt whole categories of technology. That is entirely possible. I do not know that that is what they are doing. But there will be an effort made to restrict the list; that is to build more secure walls around many fewer products.

If that means——

Mrs. **Kennelly**. That is a good direction.

Secretary **Baker** [continuing]. Excluding a whole area of technology, maybe so.

Mrs. **Kennelly**. We have gone from hoping for the list to maybe getting a shorter list and that, seriously Mr. Baker, that is progress.

Mr. Baker, some of us on the Ways and Means Committee were in South America. There is such excitement down there, and hope that we have a block in this hemisphere now, a Northern block and you have a European trade block and, you have, of course, the East.

But then when you begin talking about intellectual property rights, or services—a curtain goes down. And I just think given how far we have come, this is the perfect time to insist that some of our research and development be respected. And I would mention that to you.

Secretary **Baker**. Absolutely. That is one of our primary goals, as you know, in the Uruguay round, and that is where we are fighting that battle, but it is very important.

Mrs. **Kennelly**. And it is a tough one, I can see, from this.

Secretary **Baker**. It is.

Mrs. **Kennelly**. Mr. Secretary, one last thing and you have been very good about these questions. Lithuania—you make it very clear that you want to be clear and unambiguous.

However, when you were talking about Rumania and Bulgaria and what we can do to improve their efforts toward reform, you said the United States has to be convinced that they are committed to democracy and freedom before we move.

And then you look at a situation like Lithuania, and we never recognized the annexation of Lithuania. And yet, we have a President there now and a parliament that has reestablished the Republic of Lithuania and yet, we are very cautious.

How do you explain that back home to a constituent when you say, you want to make sure there is a commitment and then you see this commitment. How do we differentiate when we talk about what we are doing?

Secretary BAKER. We do not—and I am not making a distinction. At least I do not think I am making a distinction. We just said that we think that the questions of the Baltics are questions that have to be resolved through dialog.

There has been, I think, a recognition, certainly there have been statements on the part of the Soviet leadership, that ultimately independence is what is going to happen, if that is what the Baltic States decide as a matter of self-determination.

The argument there today is over the process of whereby you get there. And they are hung up on that argument. But I am not suggesting that we are looking any differently at the two situations. We are not.

Mrs. KENNELLY. OK. Thank you, Mr. Secretary and thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. McGrath will inquire.

Mr. MCGRATH. Thank you, Mr. Chairman and welcome Secretary Baker.

I think all of the questions on Jackson-Vanik have been asked ad nauseam. Let me try one more.

Would it be correct to categorize the position of the Administration that the Soviet Union has come far enough in its immigration policies and human rights policies to either first, waive Jackson-Vanik for a longer period than 1 year; or second, repeal it outright?

Secretary BAKER. Did you say, would it be the position of the administration to do one or the other?

Mr. MCGRATH. Well, what would the position be on each of those?

Secretary BAKER. Our position, Mr. McGrath, is that if the Soviet Union—without getting into hypotheticals—our position is, if the Soviet Union codifies their more liberal immigration policies that they have been pursuing and enters into a commercial agreement satisfactory to the United States, we would waive Jackson-Vanik.

Mr. MCGRATH. And not repeal it?

Secretary BAKER. And not repeal it.

And that was the position that the administration took in Malta when President Bush met with President Gorbachev.

Mr. MCGRATH. Would there be, after the more liberal immigration law were signed over there, would there be any quota for which we would agree would be a level of immigration that would be necessary in order to—you know, while they may sign an agreement they may put up some impediments to open immigration—

would there be a quota of say maybe, 60,000 a year or 100,000 a year? Or would just the fact of that newly signed law be enough to allow us to waive Jackson-Vanik?

Secretary **Baker**. If the provisions of the law were sufficiently broad and flexible to permit continued free immigration—we are talking about free immigration, we are not talking about free immigration for 1,000 people, but not for another 5,000, I mean we are not talking that way. The issue of numbers, I think, comes up only in terms of the numbers we can take into the United States.

Mr. **McGrath**. What would you consider to be an impediment to free immigration? Would the cancellation of an agreement to allow direct flights from the Soviet Union to Israel be an impediment? Would that have anything to do with the ability of our Nation to waive Jackson-Vanik?

Secretary **Baker**. Well, let me say that we have been encouraging the Soviets to follow through on that agreement and to resume or to permit the implementation of the agreement for direct flights.

We have not taken the position that the failure to do so would be a bar to consideration of MFN. But we have been—every time we meet with the Soviets we press them on the question of resuming or establishing direct flights between Aeroflot and El Al Airlines.

When I last met with the Foreign Minister of the Soviet Union, here in Washington in April, he left me with the impression that he would be discussing with Israel the question of assurances of where those Soviet Jewish emigres might settle. And so I am a little hopeful, Mr. McGrath, that maybe we can find a way to implement the direct flights agreement.

Mr. **McGrath**. Off that subject, Mr. Secretary, I too was on the trip to the Central American, South American, and Caribbean nations, and one fear of the presidents and the ministers of finance and economics and trade that we encountered there, was because of the events in Eastern Europe and the need to finance perhaps or allow greater access to trade with the Eastern European countries that they felt that it would be, it is possible that they could be left behind or become second nature to us in regard to trade and the CBI agreements.

Would there be any way that you could assure these presidents of these nations that that is not so. That they are as important to us now as they have ever been, and they would certainly have an equal opportunity under the policies of our administration to trade with their countries?

Secretary **Baker**. Well, there are two ways that I can think of that would give them some pretty good assurance, Mr. McGrath.

One would be to pass the President's supplemental request.

Mr. **McGrath**. I heard you say that.

Secretary **Baker**. Yes, and I am going to keep saying it, but it is true. And it would be a shame, in fact, it would be worse than that if we find ourselves all hung up here on that bill on the day that Ms. Chammoro is inaugurated in Nicaragua on April 25, because that was a significant victory for freedom and democracy and we really should be able to respond accordingly.

I really have to tell you that I worry that we are succumbing to the temptation to play politics with something that is extraordinarily important, and that is freedom and democracy in Central America.

Another way we could send the signal loud and clear, I think, is to do something along the lines that I suggested a minute ago about the Caribbean Basin Initiative, for the countries of the Caribbean and for the Andean drug-producing countries particularly.

All we need to do is to open up a little bit in apparel, textiles, and footwear and it will do more good than anything in the world that we could do. And it would send a clear signal that we are not forgetting them because of Eastern Europe, that is we are not forgetting them because of Eastern Europe.

And there is one third thing in addition to those two that I would like to mention. And that is this problem of earmarking that I have testified before other committees with respect to, but not before this committee. We are severely constrained in the flexibility that we have to deal with foreign assistance in a time of dynamic change around the world, because so much of our foreign assistance is earmarked up here on the Hill, we have practically no flexibility to respond to a Panama or a Nicaragua, or an Eastern Europe as it occurs. And that is why we are up here so often before you on supplementals.

And if we could find some way to achieve some flexibility with respect to the earmarking in the foreign assistance budget, it would go a long, long way.

Mr. McGrath. In other words, Mr. Secretary, you would be supportive of the Ways and Means CBI II proposal rather than the Senate, as the presidents of all of those other countries have indicated to us?

Secretary Baker. I would be strongly in favor of expanding and strengthening CBI and eliminating the sunset provision that is now in CBI.

It is the most important thing that we can do for those small Caribbean countries that are helping us in the drug war and for the producing countries in Central and Latin America—producing and transit countries that are helping us in the war against drugs.

And all it involves, all it really involves is opening up our markets.

Mr. Pickle. Mr. Secretary, could I ask Mr. McGrath to yield to me for 1 minute?

Mr. McGrath. I do not have any time left.

Chairman Rostenkowski. The gentlemen is out of time.

Mr. Coyne.

Mr. Coyne. I will yield to Mr. Pickle.

Mr. Pickle. Mr. Secretary, with respect to CBI, we need more than just sunsetting. The House has passed a measure on CBI and it is over there in the other body.

And we are not getting any movement over there, period. It is not a substantive bill. And when you say, we have got to erase the sunset, you have got to do more, particularly in the two categories that you mentioned.

I would hope that the administration would give us some good, strong leadership because we need it.

Secretary **Baker**. I am doing that in every way I can, Mr. Pickle. I do not know whether you heard me a minute ago say that I have been making personal calls to the——

Mr. **Pickle**. Yes, I also heard you say that you had to admit that you have not been very successful and I hope you can make some more calls and be successful.

Chairman **Rostenkowski**. Mr. Coyne.

Mr. **Coyne**. Thank you, Mr. Chairman.

Mr. Secretary, if our fiscal house were in better order; if we were running $40 billion deficits instead of $150 or $160 billion deficits, would our commitment to the programs that you have initiated be at a greater level in nuts and bolts items and humanitarian assistance and technical assistance to the countries of Eastern Europe?

Secretary **Baker**. Are you saying if we had a deficit of only $40 billion, versus $150 or whatever it is, would we have a little bit more flexibility to deal with these?

Yes.

Mr. **Coyne**. And would you, as Secretary of State, be recommending higher levels of assistance to the countries of Eastern Europe?

Secretary **Baker**. No, I am not sure we would recommend higher than what we have, Mr. Coyne, because we have come in with substantial supplementals and we have generated again, through the multilateral process I mentioned to you, quite a bit of assistance—over $14 billion in real money and $23 billion if you look at extended, I mean restructured loans.

So I am not sure I could say that. But I would say that if it was $40 instead of $150 or $130 billion or whatever it is, I think there would be a better chance of getting some of the funds that we request to support freedom and democracy around the world.

I will say that to you, because I think that is true. At the same time, I think in looking at the fiscal situation in the country—and again this is not where I spend most of my time any more—but in looking at it, I think that we ought to realize that what is really significant is the deficit as a percentage of GNP and not the nominal number we are dealing with.

I remember when I first went into office as Secretary of the Treasury, we were looking at a deficit of 6.3 percent of our GNP. And we are now looking at a deficit of under 3 percent, somewhere around 2.6 percent, I think of our GNP. So there has been substantial deficit reduction, through the effects of Gramm-Rudman and efforts that the legislative and executive branches have made together.

Mr. **Coyne**. So we are not inhibited in developing plans for Eastern Europe and programs by our fiscal situation?

Secretary **Baker**. Well, you know, the President and I think it is fair to say, the Congress, have really been very, very aware of the importance of locking in these historic movements to democracy and freedom in Eastern Europe and in Central America.

We need to move that Central America supplemental; we need to move it badly, but I think that there has been a recognition downtown and up here frankly, of the importance of what is happening out there around the world.

Mr. **Coyne**. Thank you.

Chairman **Rostenkowski**. Mr. Levin.

Mr. Levin. Thank you, Mr. Chairman and Mr. Secretary and welcome.

You have been asked at length about Lithuania, Mr. Secretary, and I think that issue has been handled very effectively; it is the key issue of the day. So let me go on.

I would like to pick up the thread that was raised by Mr. Coyne and that is our response to developments in Eastern Europe.

I think he asked you a critical question. And that is, whether we would be doing more if we did not have a domestic budget deficit—$125 or $150 billion a year? And I very much respect your response. I suppose it is what would be expected from any administration spokesperson and surely from someone with your immense background and your immense skills.

But let me just press the point, if only to, in a small way impress upon you, if I might say so, a different perspective or a somewhat different perspective.

In the last couple of months, we have been talking to parts of the public sector, offices in various places. We have been talking a lot to the private sector, to businesses of various sizes about opportunities in Eastern Europe.

And what we are receiving back—and this is not universal but it is not isolated—comments like, it is hard to obtain information. There is a shortage of personnel. Eximbank is underfunded. Its weakness is a big problem in developing trade with Eastern Europe. That our offices do not have adequate resources, adequate access to key information. And that there are not adequate officials, Government personnel in Eastern Europe with commercial expertise.

That we are not, as Mr. Gibbons implied and he has raised this before, we are not responding with the technical resources that this country is so enriched with.

What do you make of all of that? Is that just a lot of self-serving or shortsighted responses from a substantial number of persons, both within the Government, our own Government, but mostly within the private sector?

Secretary Baker. Mr. Levin, let me make sure you didn't misunderstand what I said to Mr. Coyne first. I thought he asked me could we do more if the deficit was only $40 billion instead of $150 billion, and I said yes.

Mr. Levin. If I might just interrupt, you said yes, we could more readily implement what you have requested, but your request would be more or less the same. That is what you said——

Secretary Baker. I said we could do more if the deficit was only $40 billion because I think it would be easier to get funding, and that would probably determine to some extent what we might come up here for. He asked me also would we have done more for Eastern Europe, and I said I didn't think so, or for Panama or Nicaragua, because we have asked for and received, quite frankly, substantial sums of money for both of those. We are into, you know, with just Poland and Hungary, $1 billion, $2 billion overall if you look at this multilateral effort and count up our participation, $800 million for Panama and Nicaragua. In fact, a lot of people are saying we are asking for too much.

Mr. Levin. I agree with you on that subject. I very much supported the supplemental. But let's concentrate for a second on Eastern Europe. In terms of our own resources, marshaling our resources, despite the aid package, the SEED I program that went through here, we are receiving these comments from the business sector and from within our own Government from various offices that we are not really ready, as several Western European countries are. You just feel that that is off the wall or self-serving or shortsighted talk by the private sector and the public sector here?

Secretary Baker. Well, I would have to know a little bit more about what the exact complaints are and who is making them, Mr. Levin, but let me say this: We are not—I think it is fair to say, and we should admit, that we are not positioned quite as well to move commercially as the countries which are closer to Eastern and central Europe are. That is a fact, I think, more of geography than anything else. It is my understanding that the Eximbank has unused authority. My sense is not that we are short of budget authority or outlay authority for the Eximbank. That is not one of the problems.

Mr. Levin. We are talking about personnel, not——

Secretary Baker. Well, it is more a fact, I think, that we are all the way over here across the ocean, and we really have not had commercial relations with these countries of Eastern Europe to the same degree and extent which their neighbors have, in the past when they enjoyed free market economic systems. I think those—if they are criticisms—would be valid, but I don't think it is a function of budget, is the point I am making. I really don't, because we think these things are so important. For instance, the President even sent the Panama-Nicaragua supplemental up here with a request that if you couldn't find offsets for it, you pass it over a budget waiver. The first time in his tenure as President that he has done that. So he is not holding back, in my view, in supporting these developing democracies in Eastern Europe and Latin America.

Chairman Rostenkowski. Mr. Brown.

Mr. Brown. Thank you, Mr. Chairman.

Mr. Secretary, let me add my thanks for your coming here today. I would like to note that in the first year of your tenure, we have seen 110 million people in Eastern Europe at least given verbal assurance that they will have an opportunity to develop democracy and greater economic freedom, and the Communist Party of the Soviet Union indicated an interest in allowing private property. That is not a bad first year, and we look forward to your second year in office.

Mr. Secretary, I am concerned about the situation with regard to the emigration of Soviet Jews. It strikes me that having the right guaranteed to emigrate and then not being allowed any transportation is not a very effective right to emigrate. I can appreciate it is difficult to negotiate with the Soviet Union on this question, and I appreciate also that you have raised it in your discussions with them. But would you share with us your view? Do we intend to grant the most-favored-nation status to the Soviet Union if they pass the right to emigrate but then, in effect, refuse to allow emigration by restricting transportation?

Secretary **Baker**. You mean by restricting direct flights, by simply not going into a direct flight agreement?

Mr. **Brown**. Yes.

Secretary **Baker**. Let me say one more time, Mr. Brown, the administration's position was developed at Malta in conversations between President Gorbachev and President Bush, and it is basically that if there is a commercial agreement satisfactory to the United States and if they codify their free emigration practices, without reference to whether or not there is a direct flight arrangement, understanding, or agreement, that we would move toward a waiver on MFN. That remains the policy of the administration. Without getting into hypotheticals, that is what our policy is.

Now, let me say, as I mentioned in answer to an earlier question, we continue to work on the Soviet Union to implement that direct flight agreement. In addition to that, we are working with other Eastern European countries encouraging them, and with some degree of success, particularly in the case of Hungary, to permit direct flights from those Eastern European countries which are easily—which the emigres can reach not as easy as they could with a direct flight from the Soviet Union, but can reach with some greater ease than they could if they had to make their way without any direct flights from Eastern Europe. And I think the fact that Hungary has reinstituted direct flights is a very significant and important factor.

Mr. **Brown**. How serious do you believe the problem of transportation is out of the Soviet Union? Do we find a large number of people who now have a right to emigrate or will have a right to emigrate who simply can't get out?

Secretary **Baker**. I would be afraid to say large or not large. I would rather get to you the exact numbers, and I will do that, Mr. Brown. I think we can arrive at what the exact numbers are, and I will get them for you and send them to you. I really don't have them in my head.

Mr. **Brown**. I appreciate that.

[The information of Secretary Baker follows:]

Soviet Jews continue to obtain exit permission at a high rate. The Israeli consular mission issues more than 400 visas per day.

The Soviet Union has failed to implement a direct flight agreement reached between Aeroflot and El Al. The United States Government strongly supports the establishment of direct Soviet-Israeli air links. We have repeatedly informed Soviet officials that it is important to provide Soviet Jewish emigrants every opportunity to depart. Most recently, Secretary Baker raised this issue during his April Washington meetings with Foreign Minister Shevardnadze to stress our continued belief that such artificial barriers to emigration should be eliminated, but the responses have not been encouraging.

However, the Soviet government has placed no barriers to the movement of Soviet Jews to Israel through third countries and continues to provide exit permission to thousands of Soviet Jews each month.

We do not know how many Soviet Jews have Israeli visas but have not yet left. We understand that generally an emigrant arrives in Israel about two months after receiving a visa.

Whatever the delay, much of it can be attributed to the general shortage of transportation out of the Soviet Union and the use to date of only Budapest and Bucharest as transit points by Israeli authorities. However, there are several other factors which may add to this delay. The first is personal convenience. Many travellers have not completed making their personal arrangements at the time they receive their visas and do not even seek to leave at that time. Emigrants also face backlogs in receiving customs clearance for their household goods. This does not appear to be a deliberate effort on the part of the Soviets to slow immigration but rather a normal result of the high volume of such shipments and the inability of Soviet customs officials to deal with it quickly.

The Hungarian Airline, Malev, recently suspended flights from Budapest to Tel Aviv and refused to carry Jewish emigrants on any flights. In response to strong protests by the U.S. and Israel, the Government of Hungary fired the director of Malev and convinced the airline to resume flights and to honor all previously purchased tickets. While Malev is not presently accepting new reservations to Israel, Budapest remains the major transit point for Soviet Jews going to Israel. Even with the interruptions caused by Malev's actions, more than 7200 Soviet Jews arrived in Israel in March, 1500 more than in February. About 10,000 are expected to arrive in April.

The number of arrivals in Israel has increased markedly in each of the last four months. Israel has reached agreement with the Government of Poland to have Warsaw serve as a transit point. We understand that Israel is also exploring other routes and means of transportation. These developments should insure continued movement of large numbers of Soviet Jewish emigres to Israel in the months to come.

Mr. **Brown**. Mr. Secretary, it is kind of ironic that Yugoslavia has gone from the status of being a leader in Eastern Europe, in terms of opening up, to the follower. And I know the State Department has expressed concern about some of the developments with the ethnic Albanians in the Serbian portion of Yugoslavia. Can you give us a feel for what kind of progress you expect in Yugoslavia or what kind of concerns you have with what appears to be almost a reversal of their liberalization in Yugoslavia?

Secretary **Baker**. The Yugoslav Government has adopted, we think, a very good economic program. They are moving to implement that economic program. The major problem that that Government has, in our view, is the lack, really, or a deficiency in the authority of the central or Federal Government. The republics have a great deal of autonomy, and as has been the case in the past in Yugoslavia, you see substantial ethnic rivalries and you see nationalist tendencies arising now that they are moving tc greater political open space—greater openness and trying to move to a market economy.

One of their primary problems, frankly, is their central Government authority is not really strong enough to deal with some of these problems in the republics. I think they are trying to correct some of that.

Mr. **Brown**. Thank you.

Chairman **Rostenkowski**. Mr. Dorgan.

Mr. **Dorgan**. Mr. Chairman, thank you very much.

Mr. Secretary, I know that primarily we are discussing events in Eastern Europe today, but I would like to take you off just briefly to another subject that is important to me. I am involved in hunger issues as chairman of the International Task Force on Hunger Committee, and I would like to ask you just for a moment about our trade with Ethiopia.

As you know, perhaps the bloodiest war in the world today is occurring in Ethiopia, and literally hundreds of thousands of Ethiopians are now on the edge of starvation. We risk in from 4 to 6 weeks mass starvation in Ethiopia. I know that you have been involved in this and have made some inquiries to the Soviets.

I would like to ask a question that has two parts. First, are we working with the Soviets in any specific way to try to deal with the Mengistu government in Ethiopia to allow the international food relief to move through? Second, if that is not fruitful, is there a way for us to consider some trade sanctions against Ethiopia if the Government will not allow those international relief shipments to move? My understanding is that we buy around $60 million worth of coffee from Ethiopia. Is that under consideration at this point?

Secretary **Baker**. There is no consideration being given that I am aware of, Mr. Dorgan, to trade sanctions, and I don't think the volume of our trade is substantial with Ethiopia. We have done quite a bit of work, however, with the Soviets on the question of refugees and hunger and opening up the port of Menewa in the north. We spent a fair amount of time on that when Minister Shevardnadze was here in April. I think it is fair to say that this is the kind of area where we can find some cooperative attitude on the part of the Soviets with respect to finding a way out of these regional conflicts.

I haven't received an update over the course of the past 5 or 6 days on where we stand on some of the followup that we wanted to come out of those discussions, but I will be glad to check on it and let you know.

The Soviets are interested in well, let me say, notwithstanding their support for Mengistu, they are interested in seeing if we can find a way to permit private voluntary organizations and others to get food relief to the people in the north that run the risk of starvation. We have talked, for instance, about their weighing in with the Mengistu Government to stop the bombing of that port. I will just have to get you an update to see where we are.

Mr. DORGAN. Well, the reason I raise the question today instead of discussing Eastern Europe is the Government has begun bombing the port of Menewa again in the last several days.

Secretary BAKER. They have?

Mr. DORGAN. And the opening of the port of Menewa to international food shipments up into Tigre and Eritrea is critical to getting the food in. And my question is: Would it be at all useful for us to not only work with the Soviets, as we are doing, but if that is not productive, do whatever we can to suggest trade sanctions with whatever little effect they might have to Ethiopia to try to be more persuasive to the Ethiopian Government to allow the international relief shipments to proceed?

Secretary BAKER. I don't think it would get the job done, but I don't know any reason why we couldn't take a look at it, Mr. Dorgan. Again, I don't know what the volume of trade is.

Mr. DORGAN. Well, would the State Department at least take a look at that?

Secretary BAKER. Yes, indeed. We would be glad to.

Mr. DORGAN. And I would appreciate it, and others, I know, would as well, that as you prepare for the summit meeting, that you continue to realize that we are within weeks here of an international catastrophe. The war is one of the least reported and bloodiest wars in the world today, and the threat of mass starvation into the hundreds of thousands and perhaps millions is very near.

Secretary BAKER. Millions, probably.

Mr. DORGAN. We are talking weeks. We had someone testify the other day who just returned who said it was routine to see old women 40 feet up in trees picking leaves to eat. This is a very serious problem.

Secretary BAKER. It is a very, very tragic situation, and we are aware of that, and we are doing what we can. But I think it would be worthwhile to take a look at the trade sanction question. We will be glad to do that.

Mr. DORGAN. If you would do that, I would appreciate it. Thank you, Mr. Secretary.

[Secretary Baker's responses to Mr. Dorgan's questions follow:]

Ethiopia: Consultations with the USSR

Q. Are we working with the Soviets to try to deal with the Ethiopian government to allow the international food relief to move through?

A. Yes. We discuss Ethiopian relief in our regional meetings and in other talks in Washington and Moscow. The Soviets are well aware of the dimensions of the relief problem and are working in parallel with us to arrange an appropriate UN role on the ground. They issued a statement on the relief effort April 24, at the same time as the Western donors issued their statement of principles on Ethiopian relief. The Soviets are fully aware of our interest in seeing the port of Massawa open and our suggestions for guaranteeing safe passage for cross-border convoys.

Ethiopia: Trade Sanctions

Q. Would it be useful for the United States to impose trade sanctions on Ethiopia in our efforts to persuade the Ethiopian Government to allow delivery of international relief shipments through the port of Massawa?

A. We believe Congress's current approach of leaving the final decision to the Administration is the right one. The Defense Authorization Act respects the President's discretion. Our trade with Ethiopia is limited, and in any case Ethiopia can sell its coffee (its main export to the U.S.) elsewhere. We do not see how mandatory sanctions would increase our chances of achieving our relief objectives at this time.

Ethiopia: Status of Relief Efforts

Q. What is the status of international relief efforts?

A. Large amounts of food are continuing to be delivered via the "southern route" supplied through the port of Asseb. The target figure for the southern route is 15,000 metric tons per month, although a number of logistical upgrades -- such as repair of certain bridges and sections of the road -- will have to take place before that figure can be met. Over 6700 tons had been delivered as of April 26.

Even if that figure is reached, however, it will be insufficient to meet the full need although recent information indicates that fewer are at risk than previously thought. Nonetheless, it still is necessary for the government of Ethiopia to allow the port of Massawa to be used for a northern route in addition to the Asseb route.

On April 27 the United Nations announced that the Ethiopian government had agreed to enter into discussions of ways to permit relief food to enter Massawa. We will continue to press for the establishment of the required northern route.

Chairman Rostenkowski. Mr. Anthony.

Mr. Anthony. Mr. Secretary, I wonder if you could give us an update on the plans for German reunification. What is the current status?

Secretary Baker. Mr. Anthony, the unification of Germany is proceeding, I think, much more rapidly than people originally thought it would. And as we sit here and talk this morning, the process of the economic integration of the two Germanys is taking place on the ground.

The political unification is now in a position to begin as a consequence of the holding of elections in the German Democratic Republic and the creation of a government there. And the first contacts between the Federal Republic Government and the Government of the German Democratic Republic have commenced. We are looking, in fact, at the possibility of scheduling the first meeting of the "Two Plus Four" group that will deal with the questions of the external aspects of German unification, the two Germanys and then the four powers who have reserved rights following the end of the Second World War.

So the process is under way. I can't give you a timeframe for completion of it, and we have never set a timeframe or deadline on it.

Mr. Anthony. Has it affected in any material way the integration of Europe 1992? Has it set it back in any way?

Secretary Baker. The European Community is still firmly committed, all of them firmly committed, to EC 1992; that is, the formation of a common market, a single market by 1992, and efforts in that regard are proceeding.

I don't think that German unification is going to set that back or delay it. I can't give you an opinion about whether or not it might delay efforts within the Community by some of the members to deepen and broaden membership in the European Community and extend integration to such questions as monetary union and political union. I think it is a little early to determine whether there would be any impact one way or the other on that, although I think it is important to note that the leadership of the Federal Republic of Germany makes it very clear that they are firmly committed to the integration of the European Community, full integration of the European Community.

Mr. Anthony. Some of the smaller countries—Portugal, for instance, a late entrant into the EC—have been experiencing some very severe inflationary problems. Material I have read indicates that some of this inflationary pressure is a result of EC 1992. I wonder if you detect this to be a general trend, or if this is a special circumstance?

Secretary Baker. I have heard those reports, Mr. Anthony, but I can't say that I would say that we heard that it was a general circumstance.

Mr. Anthony. We have an awful lot of American businesses going to Europe, purchasing companies and trying to get a foothold into that market. You responded earlier to a question about whether or not we were doing enough financially to promote U.S. business in Europe that much of it had to do with geography. A lot of other countries have already been in Europe for a long time. It seems that our private business is trying to buy a toehold right now. If, in fact, these inflationary pressures exist, they would eventually have an adverse economic impact here in the United States.

Any information you run across during your travels, studies, and dialog, which you feel appropriate, to communicate to this committee for the record, I wish you would do so.

Secretary BAKER. All right, sir.

[The following was subsequently received:]

Periods of sustained inflation are typically caused by excessive monetary growth. In examining EC 1992, we see no basis for believing that it will necessarily cause inappropriate monetary expansion.

To the contrary, there may be forces at work—monetary and nonmonentary—in the EC 1992 process that will promote price level stability. For example, one study by the EC Commission has predicted that the cost savings resulting from greater competition, economies of scale, and deregulation under EC 1992 should result in an EC consumer price index about 6 percent lower—within 5 years after the program is in place—than it would have been otherwise.

In addition, most EC members—those in the European Monetary System—have agreed to keep changes in their exchange rates within a fairly narrow band. This has resulted in the strongest currency of the EMS setting the pace for monetary policy for all EMS countries. Since the inflation-conscious Germans have had the strongest currency, this system has contributed to a significant drop in European inflation during the 1980's.

Although it is difficult to separate out the effects on inflation of other factors, particularly that of German monetary union, we believe that the overall impact of EC 1992 and the parallel EMS will not involve an increase in inflation in the European Community.

U.S. firms that operate in Europe will presumably make decisions based on what is economically advantageous to them. If costs fall in Europe, U.S. business may be more likely to invest there; if not, they may invest elsewhere. The level of European inflation also affects U.S. exporters. If U.S. inflation exceeds that in the EC—other things being equal—it may be more difficult for American firms using U.S. inputs to compete in the European market, but if U.S. inflation is lower than that in the EC, it may be easier for U.S. exporters to sell their goods in Europe. Of course, if exchange rates adjust fully to reflect changes in the purchasing power of the European currencies vis-a-vis that of the dollar, trade should not be affected.

Mr. ANTHONY. I would like to close with my congratulations for a job well done, and to thank you for your appearance before this committee.

Secretary BAKER. Thank you, sir.

Chairman ROSTENKOWSKI. Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

Thank you, Mr. Secretary, for taking time out of your busy schedule. We appreciate your appearance before this committee. I was just thinking, if this tremendous first year you have had as Secretary of State continues—you know the way they called a certain period in history the "Metternich period"—we may end up with this being the "Baker period." He was a foreign minister, and you are a foreign minister. And if you continue making these marvelous advances, we may look back upon the Baker period as one of the high points in the world's history. I don't know whether you want to comment on that or not.

Secretary BAKER. I think we have been the beneficiary of a lot of good work that others have done, Mr. Schulze.

Mr. SCHULZE. Mr. Secretary, should we use trade as a lever to encourage democratic behavior, democratic institutions, democratic policies, the transition from nonmarket to market economies? Let me stop there.

Secretary BAKER. Can we?

Mr. SCHULZE. Should we. As a policy, should we utilize access to our markets or availability of trade credits, trade in the broad general sense, should we somehow develop a policy? It just seems to me—I didn't want to go on too long with a question, but it seems to me that what we are doing involved with multinational, multilateral policies and agreements, are sort of all or nothing at all, and with MFN.

I led the opposition to MFN for China, and everybody said, oh, you are just a Neanderthal protectionist. And I said no, we should have some system of graduated, increasing access. Now, I know it is always easy to look back and say you were right or you were wrong, but certainly it would have been much better if we had a system of gradually increasing access. That is why I ask the question. Or should we just say, ah, well, we will use other things, we will have a strong military and we will let them know if they step out of line, we will smack them or we will, you know, use other things rather than trade as a policy tool.

So my question basically, again, is: Should we use trade as a lever to encourage these democratic institutions and to encourage free market policies?

Secretary BAKER. Mr. Schulze, we do. I think you could argue the case both ways. COCOM, of course, is using trade as a policy tool. The grain embargo was using trade as a policy tool. I think there are a lot of people that would agree that COCOM is an appropriate use of trade as a policy tool, and maybe the grain embargo isn't.

When I was over at the Treasury, I used to talk a lot about how this country had used economic chits for foreign policy gains for a long time, and that it was my view that you could only be strong militarily or from a foreign policy standpoint, as long as you were strong economically. I haven't changed my view just because I have moved the location of my office.

MFN is conditioned. It is in our law. It is a condition. We use it as a policy tool.

Mr. SCHULZE. But, Jim, you know right now if the President pulled MFN from China, it just would not be the time to do that. I guess you believe that, don't you, that it wouldn't be the time for us to pull MFN from China?

Secretary BAKER. I think we have got to look at the whole range of——

Mr. SCHULZE. Or do you think we should consider it? Maybe I am wrong.

Secretary BAKER. The whole range of issues with respect to our relationship there, Mr. Schulze. I am not going to make a statement here that is——

Mr. SCHULZE. And I am not trying to lead you down that path. But it just seems to me that that would be maybe overly punitive or overly dramatic at this point, and that is why a phase-in.

Now, the next part of my question: As these nations go from a nonmarket economy to a market economy, first of all, do we do them any favors if we help them along the road? If we subsidize a half-developed brand of socialism somewhere between free market and Communist control, do we help them if we subsidize them in the interim? It seems to me what we should do is develop incentives after they become market oriented, after they become a market-oriented economy, and not kind of bolster them on the way.

Now, you see, that is kind of a tough position, and everybody says that is too hardline. But perhaps we can develop a policy that takes us step by step—as they do something, we do something. I would just like to have your thoughts on that.

Secretary BAKER. Well, I want to ask you if you think that we should grant MFN to Czechoslovakia, which has a centrally planned statist economy.

Mr. SCHULZE. You see, I think not, but let me tell you why: Because it is very difficult, if I can get parochial for a minute—and I represent a district and in that district they produce widgets. And in those widgets are all the Social Security taxes and our environmental taxes and all the things that we lay on these people. And in a nonmarket economy, they don't care about those things. Their concern is what products can they develop in order to get hard currency. And Adam Smith never envisioned a world in which nations developed product lines just to get hard currency.

So, you see, I think it is unfair, and I think we ought to develop a structure or a system so that as they come out of this nonmarket economy, then we gradually loosen to them.

Secretary BAKER. Mr. Chairman, let me just respond to that by saying if we do that, if we were to adopt that, then the problem that Mr. Levin and Mr. Coyne have pointed out is going to be even greater, because the United States would, in effect, be writing itself out of the development of these market economies in these newly emerging democracies until they were actually developed. And so for that reason, I think it is questionable.

Mr. SCHULZE. Thank you, Mr. Secretary.

Chairman ROSTENKOWSKI. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Chairman.

Mr. Secretary, it is a pleasure to have you before the committee. I am certainly very encouraged by your statements here.

I was particularly pleased by your response to Mr. Archer's question as it relates to the human rights issues going beyond just emigration as it relates to bilateral arrangements with the Soviet Union and other Eastern European countries. I want to go back to Jackson-Vanik for a moment and talk a little bit about what has happened since Malta.

I understand that the policy, the administration policy, was developed at Malta in regard to a waiver of Jackson-Vanik with the Soviet Union. But since Malta, there has been increased pressure on Soviet Jews to leave the Soviet Union due to a rise of anti-Semitism caused by nationalism. We have also been disappointed in the speed at which the emigration law has been considered by the Supreme Soviet. I think we all anticipated the enactment of that law prior to the now scheduled May 22 date. And, of course, our focus back at Malta was on the right for Soviets to emigrate from the Soviet Union. Since Malta, an additional problem has come up, and the Jackson-Vanik law speaks to not only the right, but the opportunity to emigrate.

Since Malta, we have had the episode of the Soviet Union blocking the Aeroflot-El Al agreement. We have seen also problems in Hungary, and although we are very pleased with our Government's response to that, there are still problems as it relates to the Hungarian issue on flights.

So I guess our concern is that although we are extremely pleased with the administration's role in the use of Jackson-Vanik to improve the Soviet Union's emigration policy, there have been changes since Malta that alarm many of us. If I understand your statement as it relates to not just the Soviet Union emigration policy, but as you talk about bilateral contacts with the Soviet Union as it relates to Lithuania and other issues involving human rights, am I correct in interpreting from your statements here that, regardless of when the Jackson-Vanik waiver is recommended by the administration, that these issues of direct flight, these issues of Soviets having the opportunity to leave the Soviet Union will still be of prime interest to the administration and will be raised at every opportunity?

Secretary **Baker**. Well, we do raise it at every opportunity, Mr. Cardin, and we also raise at every opportunity the question of the increased incidents of anti-Semitism in the Soviet Union. Without in any way apologizing for that or defending that, let me simply say to you that I don't think that increase in anti-Semitism is driven by or encouraged by the central Government. That is what we believe. I think it has happened as a consequence of an increase in Russian nationalism that is coming about because of the fact that the Eastern European countries have been permitted to go their own way toward self-determination, and there is a debate going on in the Soviet Union now about the various republics. So you have got a resurgence of Russian nationalism, and that has brought with it, unfortunately, a rise in anti-Semitism. It is also a function, perhaps, of the fact that with glasnost and perestroika, you get a lot more open debate and free expression.

We have called it to the attention of the Soviet leadership and asked that they do what they can with respect to it, and I really believe that they are trying to do that on that particular issue. But we call both of those things to their attention every time we sit down with them—the direct flights question and this matter of increasing anti-Semitism.

Mr. **Cardin**. It has made the issue of direct flights even more important because more Soviets are trying to leave the Soviet Union.

Secretary **Baker**. That is correct, because there are a lot more emigres who would like to leave.

Mr. **Cardin**. Let me just get a clarification. You were talking about the discussions with the Soviet Union on direct flight as it relates to discussions with Israel, and you were talking about bringing up the settlement of where the Soviet Jews would go. I assume you were referring to the country that those Soviet Jews were exiting to.

Secretary **Baker**. No. What I was saying was that when we bring up this question of direct flights, the Soviet Union has raised the question of where those emigres would settle. Would they settle in Israel, or would they settle in the territories? Just so you understand the position of the United States, we support Soviet emigration unconditionally, and we would like to see the direct flights reinstituted.

With respect to the question of where they settle, that is a matter for the Soviet Union to work out with Israel. And there is some indication that they are going to engage on that question, the Soviets saying if we are going to reinstitute direct flights, go forward with unlimited emigration, we would like to know that those emigres are going to settle in Israel and not in the occupied territories.

Mr. **Cardin**. My time has expired. I might want to explore this further by correspondence.

Chairman **Rostenkowski**. Mrs. Johnson.

Mrs. **Johnson**. Thank you, Mr. Chairman.

Mr. Secretary, there are three subjects that have been brought up that I am keenly interested in. I don't want to pursue them through questions, but I do want to comment.

I am very pleased that the President has given a clear indication that he will respond if the Soviets pursue economic sanctions against Lithuania. I think that clear advance notice is very important right now to the interests of a nation that we have long supported and whose future I am keenly interested in.

Second, on the issue of export controls, about which I have written you already several times in recent months, I am pleased that you are willing to push hard those negotiations so that those issues can be resolved promptly. The machine tool industry, for instance, is critical to our future and its economic health in America. It is necessary for a strong economy as well as a strong defense capability, and we certainly want to be sure that it will have the opportunity to be part of the action in Eastern Europe, and for that, relief under our export controls is essential.

Third, I strongly support your comments on the Caribbean Basin Initiative; indeed, I believe it is one of the more tragic aspects of what has gone on down here recently that the very body that has been in such conflict about military aid cannot now come together and strongly support opportunities for economic aid, the very kinds of opportunities that will have much more long-term impact than any grants or loans or anything else we could do. I wish you well in your calls to the Senate.

As to my two questions, one is narrow and probably will—what I am really asking for is exactly the right staff contact. I believe that there is enormous need and opportunity for America to work with Eastern European nations' educational institutions to provide some of the educational support that is essential to people and businesses developing a market economy. When I was in Czechoslovakia, one of the professors that I met and had quite a long, nice dinner with him and a group said, "Can you do anything to accelerate our access to copyright rights to Samuelson? You see, we have no basic text."

I do represent one of the institutions of the United States that is uniquely prepared to provide help to Poland. Central Connecticut State University has one of the most advanced Polish studies departments in the United States. We have an excellent library. We have a lot of Polish-Americans in New Britain, CT. And our university is not only uniquely prepared in a number of ways, but we also offer one of the few industrial management degrees offered in the country. We have really made it our business to know how to help industry grow and be well managed.

So I have not been able in the course of events since the passage of the Polish aid bill to find out exactly how we can become a part of that educational exchange that I think is so important and that we are uniquely positioned to participate in. And so I would hope to hear from your staff in the next day or so as to how we can more effectively get into that action in that program.

We also have Polish economists who want very much to begin providing the basic text and introductory materials that they know are needed and we know are needed. And so here we are ready to go, and we can't seem to get out of the starting gate. And I ask your help.

Secretary **Baker**. Mrs. Johnson, first of all, thank you for your initial comments, and with respect to this particular matter, let me say, as I indicated to I believe the chairman, we are looking at this question of coordinating private sector assistance to the emerging democracies of Eastern Europe. We are looking at it through the context of a democracy corps and that sort of thing, and we are coming down to the wire on getting that set up. The Deputy Secretary of State is in charge of that, and we will be back in touch with you very quickly. But the point you make is an excellent one, and that is that these countries, a lot of them—Poland is a good example, and you mentioned Czechoslovakia—really want technical help, and they want education, educational assistance.

The Czechs, for instance, when I was in Prague, the Czechoslovak Government made the point to me that they really would like for us to encourage the teaching of English in Czechoslovakia, to make arrangements for more Americans to go over—and we are doing this—because they worry about the overriding influence of some of their neighbors, and they are very anxious that their citizens learn to speak English. So we will be back in touch with you.

Mrs. **Johnson**. Thank you, Mr. Secretary.

I do want to move on to my last question, which is very important. I noticed in the body of your testimony, you mention at several different points the importance of pricing. I am very pleased that you support the Soviet Union being an observer at GATT, but I have been concerned for some time, what happens when these nonmarket countries start trading in our market economy? And how will you insist that they price in such a way that we can enforce our dumping laws and, therefore, assure the kind of fair competition that we believe in but prevent the kind of unfair competition that has eroded some of America's basic industries? This issue is not down the road a piece. It is right around the corner. Because if East Germany and West Germany become one Germany, we are very soon going to be faced with this issue of pricing products from a nonmarket economy.

What are you doing about that?

Secretary **Baker**. I might disagree with you there, Mrs. Johnson. I think when you get the unification of Germany, you are going to have a united Germany with a market economy.

Mrs. **Johnson**. You will, but there will be, then, this issue of some of those East German products coming out on our market and making sure that they are priced in a way that reflects a market pricing structure, as opposed to a nonmarket pricing structure.

Secretary **Baker**. Well, let me say this: All of these countries would like to get to a market economy as quickly as they could. Many of them are going to have a lot of problems doing it, but I am confident that the unified Germany will be a market economy country. I don't think there is any doubt about that. You may have that phenomenon you are referring to for a short period of time initially.

[Ambassador Robert L. Barry, Special Adviser for Eastern European Assistance to the Deputy Secretary, has made arrangements to brief Representative Johnson at her convenience on education and exchanges to Eastern Europe, democracy corps, and other East European issues.]

Mrs. **Johnson**. Thank you.

Chairman **Rostenkowski**. Mr. Crane.

Mr. **Crane**. Thank you, Mr. Chairman.

It is a pleasure always, Mr. Secretary, to have the opportunity to visit with you. Let me run through a variety of quickie questions based on the testimony and exchange. One is you have confirmed that our historic policy was to use MFN as a policy tool, and for years we gave it to Ceausescu, who in my eyes was probably one of the worst tyrants at least since Joseph Stalin. Like my colleague, Mr. Schulze, I tried to get the lifting of MFN for Romania, and finally Ceausescu did it himself. Now we are in a position, though, where with some reforms—infinitely more than existed ever under Ceausescu—I gather that you are demurring in consideration of trying to renew MFN with them, at least until they resolve some of their ethnic animosities.

Secretary **Baker**. Well, it is not so much the resolution of ethnic animosities, Mr. Crane, as it is the establishment of a right of free emigration, a basic right of free emigration, but also the holding of free and fair elections. We are not going to do anything beyond humanitarian assistance with Bulgaria and Romania until they follow through on their commitments to hold free and fair elections.

Mr. **Crane**. Let me ask you a question, then, in that same context with regard to developments going on in Lithuania. Since we have never recognized the legitimacy of the forced incorporation of the Baltic States, could we not in the face of some of the implicit threats, if not explicit, from Mr. Gorbachev as to actions that he might take against Lithuania if it doesn't bend to his will, could we not open up tentative talks with Lithuania about extending them MFN?

Secretary **Baker**. Mr. Crane, our policy, of course, is to encourage dialog to resolve this question. If we move to the position you are suggesting, we are basically taking a position that would run counter to our policy of trying to see them sort it out and work it out through peaceful means and through dialog. We don't know yet whether this threat is going to be carried out. I think I have made it pretty clear this morning. The President, I know, has made it clear that if it is carried out, there will be an appropriate response on the part of the United States.

Mr. **Crane**. Would that response possibly include extension of MFN?

Secretary BAKER. We have consistently refused to speculate about what we would or would not do or might or might not do, Mr. Crane. I don't want to start now. Once the threat is carried out, if it is carried out—and when I left to come up here this morning, I checked specifically, and so far we do not have that evidence yet. I am not going to say it is not going to be, but we don't have it yet—that will be the time that we will determine what the appropriate response is.

Mr. CRANE. In yet another geographic area, Namibia, when we imposed sanctions against South Africa, we included Namibia as a recipient of those sanctions. Have those sanctions, now that Namibia has achieved independence, been lifted?

Secretary BAKER. Yes, sir; they have either been lifted, or they are in the process of being lifted.

Mr. CRANE. It does not require legislation, then?

Secretary BAKER. I will have to check on that, Mr. Crane. If it does, we are drafting the legislation, because we made it very clear to the Republic of Namibia on the day of their independence that we would be lifting those sanctions.

Mr. CRANE. On the question of South Africa, with the actions taken by the South African Government in releasing Nelson Mandela, trying to move toward the dialog with the view of establishing democratic institutions, I am not suggesting the extension of MFN, but do you think it is prudent, in the face of the movement that has been made down there, to maintain the economic sanctions? Or should we consider following the policy of Maggie Thatcher?

Secretary BAKER. For the time being, I think we ought to stay right where we are, Mr. Crane, and the debate in the United States really should not be on the issue of sanctions. It ought to be on what we can do to move the parties to serious negotiations that would bring about the establishment of a nonracial free-market democracy in South Africa. That is our goal, and we think we will get there—we would best get there by encouraging the parties to begin negotiations. We are encouraged by the fact that they have now set a date for President de Klerk to sit down with Nelson Mandela and begin some of these discussions. Of course, we have all the questions of who is going to represent the black majority and how those representatives are going to be chosen and selected, and all those issues still to be determined.

Mr. CRANE. One quick and final question. Our fifth largest trading partner is Taiwan, and they have indicated a desire to be a member of GATT. And that is imposing some liberalization on some of their previous policies. I know that we recognize them simply now as a province of mainland China. On the other hand, recognizing the reality of them being the fifth largest trading partner of the United States and the fact that they are totally removed from any of our formal trade agreements, do you not think it would be prudent to permit Taiwan to become a member of GATT?

Secretary BAKER. Well, as you know, there are substantial political problems with that, Mr. Crane, and that is not a position that we have taken as yet.

Mr. CRANE. Thank you, Mr. Secretary.

Chairman ROSTENKOWSKI. Mr. Shaw.

Mr. SHAW. Thank you, Mr. Chairman.

Mr. Secretary, I would also like to express my appreciation for the time that you have spent with this committee here this morning. I would like to follow up, if I might, on some comments and questions made by Mr. Crane regarding our relationship with South Africa.

I spent the last week in that region of the world, and during that period of time, I spent several days with a gentleman by the name of Ralph Meyer, who is a member of the Parliament. He is the Deputy Minister of National Education and Constitutional Development and one of nine on the Government's negotiating team with the black majority in trying to establish some constitutional reform and hopefully a democracy of some sort for South Africa. He also happens to be one of the recognized moderates of the ruling party in that particular country.

He was expressing to me some great concern that he and many who feel as he does about the necessity of reform of being threatened from the far right, and there is also a great deal of apprehension and concern that developments might deteriorate and that reaction from the free world will not be sufficient in order to cause their cause to go forward. This is of great concern among the moderate whites who do want to move the process forward.

It was brought up to me—and I would like to bring it up to you—I know that there is not going to be a radical lifting of the sanctions such as Great Britain seems to be moving towards. But if there would be some small gesture, even the resumption of landing rights for South African Airlines or something within this country to show that there is a recognition, a recognition of movement and support in order to give the moderates in that part of the world some acceleration so that we don't find that the far right begins to circle the moderates and the moderates disappear in their efforts.

Secretary **Baker**. Mr. Shaw, I understand the point you are making. And I would argue to you that we have already sent that signal very clearly by virtue of the fact that I went to South Africa and met with President de Klerk and with the Foreign Minister. I think we sent the signal very clearly by virtue of the fact the President has invited President de Klerk to the White House.

We have thereby ended our diplomatic isolation of South Africa. But that, of course, was never one of the formal sanctions that we had in place. And the sanctions that we do have in place, as you well know, are governed by statute. And so there are certain things that have to be done before those sanctions can be released or suspended or eliminated.

So I would argue to you that we have sent the signal very, very forcefully and very vigorously, that we support what has been done by the South African Government in terms of releasing Mandela. We would like to see the state of emergency lifted. We would like to see all political prisoners released. But, above all else, we would like to see the parties sit down and start negotiating the elements of a system that would end apartheid in South Africa.

Mr. **Shaw**. I do recognize that. But the point that I would like to make is that I hope that as the progress continues, and the important work obviously is ahead of them, what they have done now is tokenism compared to the road that is ahead of them. But I would hope that, as progress is made, that there be a relaxing of the tensions to recognize that there is a definite need for the moderates to be encouraged and for visible things to happen so that the country that the white minority does recognize, that the position of the moderates is a way ahead for South Africa.

I would like to ask you one further question, following up on Mr. Gibbons' earlier question with regard to Cuba, and coming back to this hemisphere.

You mentioned that you are bringing up with the Soviets in discussing their aid to Cuba, specifically have we set any conditions, or do you feel that it would be desirous for us to set some conditions in our negotiation—economic negotiations with the Soviets, that they in some way curtail their military aid to Cuba, Castro's Cuba at this time?

Secretary BAKER. We haven't set expressed conditions, Mr. Shaw, but we made very clear our displeasure with the delivery, for instance of Mig-29 aircraft.

Just for the record so that you will know, the answer we get back on something like that is that's a commitment that was taken 4 or 5 years ago, and it is not just aid or assistance. We get value received for it in the form of sugar and things like that.

But, yes, we make our displeasure known, as I indicated earlier, quite frequently. Because we look forward to the day when we can have a completely democratic Western Hemisphere. And we are very close with the results in Nicaragua. If we can end the insurgency in El Salvador and eliminate that threat to democracy—and, by the way, Cuba is a large part of that—but if we can do that, we can look forward, I think, to the day when we have a totally democratic Western Hemisphere. Cuba is, of course, the single exception right now.

Mr. SHAW. Yes, sir. Well, I appreciate that. And I very much appreciate the good work that the administration has done in this hemisphere and the tremendous progress that we have made in which Castro now is isolated as a dinosaur destined for extinction, hopefully within the next year.

Thank you.

Chairman ROSTENKOWSKI. Well, Mr. Secretary, I kept you about 25 minutes more than I told you you would be here. But I want you to know how much we appreciate your sharing your views with us.

I would like to conclude that our congressional delegation just returned from South America and the Caribbean. A great number of those countries that we visited, namely Argentina, Brazil, Costa Rica, and Barbados, worry about whether the old adage, "The first shall be last and the last shall be first." will prove to be true. They are wondering about all the improvements and the economic sacrifice that they are undergoing and note that they just don't want to be overlooked.

I just wanted to close on that note—that I like the idea of creating in this hemisphere a good trading block. But I think if we are going to continue to have the carrot for democracy, that we have got to continually nurture the help for all those countries that we have in our hemisphere.

Secretary BAKER. Mr. Chairman, I very much agree with that. And we support your position on that, and the position that the committee has taken. And we will be pleased to work with you to do what we can to obtain greater assistance, particularly through trade measures and access to our market for these small countries in the Caribbean and for some of the drug producing and transit countries in South America.

Did you tell them that some of the most powerful figures on Capitol Hill were strongly supportive of some of the countries in Eastern Europe, Mr. Chairman?

Chairman **Rostenkowski**. I didn't mention that. But I will go back.

Thank you very much, Mr. Secretary.

The committee will resume its sitting at 2:15.

[Whereupon, at 12:28 p.m., the committee recessed, to reconvene at 2:15 p.m.]

[The following was subsequently received:]

United States Department of State

Washington, D.C. 20520

MAY 7 1990

Dear Mr. Chairman:

Following the April 18 hearing on the U.S. Trade Relationship with the Soviet Union and Eastern Europe, the Implications of "Europe 1992" on American Direct Investment, and Foreign Investment in the U.S. at which Secretary Baker testified, additional questions for the record were submitted by Representatives Kennelly, Andrews, and Sundquist.

Please find enclosed the responses to those questions.

Sincerely,

Janet G. Mullins
Assistant Secretary
Legislative Affairs

Enclosures:
As stated.

The Honorable
Dan Rostenkowski, Chairman,
Committee on Ways and Means,
House of Representatives.

COCOM
Question Submitted to Secretary Baker by Representative Kennelly, House Ways and Means Committee
April 18

Q: Some have argued that COCOM is in danger of disintegrating because the allies no longer think it is relevant to the trade realities -- or indeed, to the strategic realities of the 1992. How would you counter such arguments, particularly when we have been so unwilling to revise the COCOM list up until now?

A: Our COCOM allies fully share our belief that COCOM remains a necessary and important element of our mutual security. However, like us, they recognize that COCOM must adapt to the new East-West strategic environment. The U.S. is willing to revise the COCOM control list. We are fully committed to streamlining the control lists to the greatest extent possible while protecting vital national security interests. The streamlining process in COCOM has not always produced results as quickly as we or our Allies would like. In light of the need to adapt COCOM quickly, COCOM members agreed in February to an ambitious work program to accelerate streamlining and achieve significant results in time for a High Level Meeting in June.

COCOM and Eastern Europe

Question submitted to Secretary Baker
by Representative Kennelly,
House Ways and Means Committee
April 18, 1990

Q: In last Wednesday's Washington Post, Kurt Steves, International Vice President of the German Federation of Industry said that he did not want to see COCOM become obsolete because of a lack of consensus. Is that concern echoed in the Administration? And what have you done to ensure that there will be consensus in COCOM at the High Level Meeting in June?

A: All COCOM members, including the United States, are working to adapt COCOM to the dramatic changes occurring in Eastern Europe and the USSR. From the comprehensive review ordered by the President, we now have thorough analyses by the Joint Staff and the intelligence community of what our principal concerns regarding national security export controls should be in this new era. Based on these analyses, the Department of State, in cooperation with the Departments of Defense, Commerce, Energy and the Joint Staff, is coordinating formation of a comprehensive proposal for presentation to COCOM by the end of April. We expect our proposal to provide for significant new streamlining that our partners and industry will welcome, yet still protect essential national security interests. We will be consulting intensively with our COCOM partners as the June High Level Meeting approaches.

COCOM and Eastern Europe

Question submitted to Secretary Baker
by Representative Kennelly,
House Ways and Means Committee, April 18, 1990

Q: Mr. Steves was also quoted as saying that when we look at the situation in East Germany we find that it is necessary to have the same machine tools and have the same computers in the factories in the East as in the West. The Defense Department has argued that they do not need such up-to-date equipment. What arguments can we make to convince the Eastern Europeans that it is not in our national interest to sell them the tools to modernize their outdated economies?

A: The U.S. and its COCOM partners recognize the fundamental changes that are occurring in Eastern European nations and the importance of controlled technology to the development of many of their economies. We support the economic and political reforms underway in these countries that have led to a new East-West strategic environment. While COCOM will continue to be an important element of Western security, it is in our national interest to ensure that it adapts to the new situation and does not become a barrier to legitimate civil trade.

We have completed a presidentially-mandated strategic review of our COCOM policy. Based on that review, we are currently developing a comprehensive proposal for COCOM, which will be completed prior to the June High Level Meeting of COCOM. We expect the proposal to move significantly beyond the streamlining proposals we presented to COCOM in February.

COCOM and German Unification

Question submitted to Secretary Baker
by Representative Kennelly,
House Ways and Means Committee, April 18, 1990

Q: It is my understanding that there are few, if any, border checks on cars and trucks going into East Germany. If that is the case, how can we continue to enforce strict COCOM standards on East-West trade? Doesn't that new situation on the borders argue for a signficantly reduced COCOM list that concentrates more on technology and less on the products, since the products are so difficult to control in the 1990s?

A: While the Administration is working hard to modernize COCOM largely as a result of the dramatic changes in Eastern Europe, I would not equate the events in Germany with events in other Eastern European nations. The two Germanys are heading toward full economic and political union. The unification of East and West Germany creates a unique and complex situation in the area of strategic trade. You are correct to conclude that it is difficult to enforce strict COCOM standards when the border is rapidly disappearing between a COCOM partner and a proscribed destination. An additional factor is West Germany's tremendous national desire to participate in the economic restructuring of the GDR. However, the FRG also understands the need to protect Western security interests and recognizes its responsibilities under COCOM. We are working closely with the government of the FRG on a proposal we think will deal effectively with technology transfer issues with the GDR.

Economic Reform in the USSR

Question Submitted by the
House Ways & Means Committee, April 18
by Representative Andrews

Q: At what point do you think the Soviets will have an economy that is predominantly market-based?

A: Many economists believe that under the current economic reform program the USSR is not likely to reach a market-based economy during this century. President Gorbachev apparently recognizes this fact, and has directed his advisors to draw up a new plan that would provide for a speedier transition to a market-oriented system. But until the new plan is published, it is impossible to assess how rapid or successful its implementation is likely to be.

Commercial Satellite Launches

Questions from the House Ways and Means Committee
April 18,1990.
By Representative Andrews

Q. (W)hat steps will be taken to ensure that U.S. producers of services, like commercial satellite launch services, are not excluded by non-market based pricing? How can US satellite launch companies compete with Soviet products whose prices are significantly scaled-down and government-subsidized?

A. The competitiveness of the domestic launch industry is one of many factors being evaluated in the National Space Council's review of US commercial launch policy. They expect to complete that review by June 1.

The State Department's aim is to enhance the launch industry's competitiveness in ways that do not inhibit free trade. Upgrading launch vehicle technology, currently based on designs of the 1950's and 1960's, may be a way to lower costs and improve reliability. Establishing "rules of the road" for commercial launches may be another way to ensure all remain competitive.

I have given you just two examples of ideas being considered. In considering options for protecting the launch vehicle industry, however, we must be careful not to harm the business interests of other sectors of the U.S. commercial space industry. Once the review is completed, I will be pleased to provide more details.

IRAQI STATEMENTS ON CHEMICAL WEAPONS

Question submitted for the record
by Representative Sundquist
House Ways and Means Committee
April 18, 1990

Q. Iraq's statements regarding the use of chemical, biological and nuclear weapons in the Middle East have been termed "inflammatory, irresponsible and outrageous" by the State Department. Recent attempts to smuggle nuclear trigger devices and the testimony of numerous arms experts, including government offifials, prove that in fact Iraq is developing or already possesses biological and nuclear capability, despite repeated denials. Iraq has proven its willingness to use these weapons against Iran and its own people, and has recently deployed missiles within range of Israel and threatened to use them.

A: We share your concerns about Iraq's efforts to develop non-conventional weapons. The U.S. takes an active role in attempting to hinder the proliferation of such weapons to Iraq and other countries of the region.

We have raised with Iraq at senior levels the irresponsible statements made by its president and senior officials, as well as recent Iraqi actions such as deployment of missiles and attempts to procure military electrical components illicitly. In addition, Senators Dole, McCLure, Metzenbaum, Simpson and Murkoswski expressed their concerns directly to President Saddam Hussein on April 12. We believe our message has been received, and we are looking closely at Iraqi behavior.

Our efforts inside the U.S. center on effective export controls to insure that there are no transfer to Iraq of the means necessary to develop nuclear, chemical and biological weapons, and the missile systems to deliver them. We forbid the export of fifty chemical weapons precursors to Iraq and several other countries of the region.

Multilaterally, we work with our friends in the Australia Group and the Missile Technology Control Regime to harmonize the export controls of many nations to deny CW precursors and missile technology to Iraq and other countries.

We are also at work on a political level to reach international agreements on non-conventional weapons. At the Conference on Disarmament in Geneva, we are working with seventy nations to achieve a comprehensive ban on chemical weapons. Iraq has joined the CD as an observer. Iraq has also signed the 1972 Convention on Biological Weapons, although it has not deposited an instrument of ratification. Iraq is a party to the Nuclear Non-Proliferation Treaty. We have urged Iraq and all states of the region to adhere to the commitments enshrined in the NPT. All fissile material known to be in Iraq is under IAEA safeguards and inspection.

United States Department of State

Washington, D.C. 20520

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COMMITTEE ON WAYS AND MEANS
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Dear Mr. Chairman:

Following the April 18 hearing on U.S. Relationships with the Soviet Union and Eastern Europe, the Implications of "Europe 1992" on American Direct Investment, and Foreign Investment in the United States at which Secretary Baker testified, two additional questions for the record were submitted by Representative Chandler.

Please find enclosed the responses to those questions.

Sincerely,

Janet G. Mullins
Assistant Secretary
Legislative Affairs

Enclosures:
As stated.

The Honorable
Dan Rostenkowski, Chairman,
Committee on Ways and Means,
House of Representatives.

COCOM

Question Submitted to Secretary Baker
by Representative Chandler
House Ways and Means Committee
April 18, 1990

Mr. Secretary, COCOM is becoming an increasingly important issue for us with our allies. It has been reported that our allies think that we are out of step with reality. They argue that the proposals we have made thus far for revisions in the machine tool list prove their point. I have heard that the Defense Department has dug in its heels and will agree to no further changes in that list. What would your predictions be with regard to revisions to the COCOM list, particularly with regard to machine tools, and would you be willing to make a prediction with regard to how our allies will react to the proposals we make at COCOM?

The U.S. put forward interim proposals for the modernization of COCOM at the special meeting of COCOM's Executive Committee in February. In machine tools, and some other areas, many of our COCOM partners believed we should have gone farther, faster. Note, however, that the February proposals were interim only. The President ordered a comprehensive strategic review of our COCOM policy that has now been completed. Based on studies done by the Joint Staff and the intelligence community, the Secretary of State is coordinating formation, by the end of April, of a comprehensive proposal. While many details, including the machine tool control levels, remain to be worked out, we expect the new proposal to provide for deeper and broader streamlining of the COCOM control list than did our interim proposals. As soon as the proposal is complete, we will begin consultations with our COCOM allies. Along with the U.S., they are convinced of the continued importance of COCOM to our mutual security, but recognize the need to adapt it to the new East-West strategic environment.

COCOM: Machine Tools

Question Submitted to Secretary Baker
by Representative Chandler
House Ways and Means Committee
April 18, 1990

Mr. Secretary, I was pleased when the Administration announced a commitment to streamline the COCOM list in the areas of computers, telecommunications, and machine tools. It is my understanding, however, that there is a great deal of disagreement within the Administration as to what level of machine tool technology to allow to be sold to the Soviets. As you know, the machine tool list has not been revised since 1974. Do you believe you can overcome inter-agency disagreement soon enough to present a new proposal to the COCOM allies at the High Level Meeting in early June? Would you predict that the U.S. position will contain the significant changes in the machine tools list necessary to bring it in line with the strategic reality of 1990 instead of 1974?

Our interim proposal on machine tools contained significant liberalization of the control parameters. For example, we proposed moving the positioning accuracy control from ±10 microns to ±5 microns. However, most of our COCOM partners would like to see more liberalization.

Machine tools, along with computers and telecommunications, was identified by COCOM members in February as a "priority sector" for accelerated streamlining. The machine tools working group has been instructed to complete its work, using the China Green Line as a reference point, prior to the June High Level Meeting. In the U.S., the issue is being examined carefully at high levels. It would be unwise to speculate on the outcome of our deliberations, but, based on the comprehensive strategic review ordered by the President, we expect to produce a proposal that is in full accord with the strategic realities of 1990.

AFTERNOON SESSION

Chairman **Rostenkowski**. We will come to order.

Mr. Secretary, I understand that you have to leave by 4:15 so we will try to move this along as quickly as possible. I think you will have to bear with us, however, if there are some votes on the floor. We just don't have the benefit of all the time that you can give us, but we will try to work it into 4:15.

I would like to welcome you this afternoon to this meeting, Mr. Secretary. We conclude our series of hearings on the issues of foreign direct investment in the United States, "Europe 1992," and U.S. trade relations with the Soviet Union and Eastern Europe.

We are certainly happy that we could get Secretary of the Treasury Nicholas Brady to testify on these issues. I am sure he will bring importance to the critical work that is being done, and the work that this committee will have to be legislating in the near future.

Over the last few months, we have had several witnesses testify that we should consider changes to U.S. tax policy to respond to the European Community's plan for an integrated market in 1992, and to respond to fluctuations in the amount and the nature of foreign investment in the United States.

Changes in Eastern Europe continue to occur daily as these countries move toward market based economies. Their future relationship with Western Europe, the United States, and the rest of the world will continue to develop in the months ahead. We will closely monitor the progress of these changes and their impact on U.S. businesses, both at home and abroad.

We will also exercise caution in any decision to change our tax policy to respond to changes in the global economy.

Mr. Secretary, we welcome this opportunity to hear from you and to receive your assessment on these issues. We are looking forward to suggestions for appropriate responses that should be considered by this committee.

Mr. Archer.

Mr. **Archer**. Mr. Chairman, thank you. I also want to welcome the Secretary before our committee once again. We appreciate your taking the time to share with us today your views about many of the things that are happening in a very exciting world. And I look forward to your testimony.

Chairman **Rostenkowski**. Are there other comments?

[No response.]

Chairman **Rostenkowski**. If not, Mr. Secretary, welcome. It is always nice to have you with us. The time is yours.

STATEMENT OF HON. NICHOLAS F. BRADY, SECRETARY, U.S. DEPARTMENT OF THE TREASURY, ACCOMPANIED BY CHARLES H. DALLARA, DEPUTY ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS, AND KENNETH W. GIDEON, ASSISTANT SECRETARY FOR TAX POLICY

Secretary **Brady**. Thank you, Mr. Chairman.

I would like to ask your permission to incorporate my full testimony in the record.

Chairman ROSTENKOWSKI. Your entire statement, Mr. Secretary, will be included in the record.

Secretary BRADY. I am pleased to appear today to discuss developments in Eastern Europe, the European Community, and foreign investment in the United States. The United States has entered into discussions with Eastern European countries aimed at reaching agreements to improve trade, business, and investment conditions.

The United States, along with other donor countries, organized a $1 billion multilateral stabilization fund for Poland to provide support for the zloty. A business and economic relations treaty with Poland was signed last month. Last week, the United States signed a trade agreement with Czechoslovakia.

We have income tax treaties currently in effect with Hungary, Poland, and Romania. These treaties are close to the U.S. and OECD models and should not need revision.

We hope to begin negotiations soon on tax treaties with Bulgaria and Czechoslovakia, and to resume negotiations with Yugoslavia. Tax treaties form an important economic link with Eastern Europe, as with other countries, because they facilitate bilateral investment flows and U.S. business opportunities. Specifically, they eliminate double taxation; they establish a government-to-government communication and dispute resolution system for tax matters; they raise thresholds of activity necessary for a foreign country's tax system to apply; and they reduce foreign taxes reciprocally on investment income.

The United States strongly supports European economic integration. The Treasury has followed the full range of issues with a focus on financial and investment issues. The EC's plan to liberalize European financial markets and to harmonize investment regimes will lead to more efficient and competitive capital markets and a more efficient allocation of capital.

With regard to taxes, we are closely following EC 1992. The pace of harmonization among EC countries in the area of taxation, however, particularly taxation of income continues to be slow. This is to be expected considering that EC member states have strongly held, diverse views on tax issues, and that EC tax directives require unanimous consent among all EC members.

Within the EC, authority in the area of taxation is retained by each individual state. A single tax treaty with the EC therefore is not a realistic possibility in the foreseeable future. But we will follow developments and respond as necessary.

With regard to foreign investment, the United States welcomes foreign direct investment and encourages other countries to do likewise. We create exceptions to our open investment policy only as necessary to protect national security.

At a time of relatively low domestic savings, foreign investment helps us maintain high levels of investment, which is so important to our economic performance. A major goal of the administration is to improve national savings and domestic capital formation.

Our tax policy toward foreign investment in the United States is to tax foreign investors fairly, reasonably, and in accordance with international norms that reduce tax barriers to international transactions.

We have entered into a broad network of tax treaties to help U.S. business to achieve the same open door abroad that we offer foreign investment here. We expect to continue these policies.

We have seen an increased willingness of Congress to override treaties in recent years. Although we are encouraged by recent developments, we continue to be concerned. Treaty overrides may be the single most controversial issue in our international tax relations. They have resulted in threats of retaliation and more tangibly in the clear prospect of less desirable outcomes to the United States in recent treaty negotiations.

The solution to this problem lies, I believe, in regular consultation between the administrative branch and Congress. Such consultations should assure that legitimate legislative goals will not be frustrated by a rigid or antiquated tax treaty program while, at the same time, permitting our treaty program to continue to develop to meet changing conditions and needs.

Thank you very much.

[The statement of Secretary Brady follows:]

For Release Upon Delivery
Expected at 2:00 p.m.
April 18, 1990

Statement of the Honorable
Nicholas F. Brady
Secretary of the Treasury
before the
Committee on Ways and Means
United States House of Representatives
April 18, 1990

Mr. Chairman and Members of the Committee:

I am pleased to appear today to discuss developments in Eastern Europe, the European Community, and foreign investment in the United States. Developments in these areas will have an important bearing on the U.S. economy for the rest of this century and beyond.

EASTERN EUROPE

In Eastern Europe, economic conditions have been a critical factor behind the political changes that have swept across the region during the past year. Most of the Eastern European countries are undertaking comprehensive, market-oriented reform programs. To encourage their efforts, the U.S. Government is providing financial and technical assistance and is negotiating trade, investment, and tax treaties.

Financial Assistance

The United States responded quickly with financial assistance to the developments in Eastern Europe. In fiscal year 1990, the Support for Eastern European Democracy (SEED) Act provided $418 million in aid to Poland and Hungary. The United States, along with other donor countries, organized a $500 million multilateral bridge loan for Poland, which has already been repaid. In addition, the United States coordinated a $1 billion multilateral Stabilization Fund for Poland to provide support for the Polish zloty as the economic reforms -- including limited convertibility -- were implemented. This year the Administration has proposed legislation to expand our assistance effort to all of the emerging democracies of Eastern Europe, requesting $300 million in fiscal year 1991 for this purpose. Finally, a large variety of activities are being undertaken to support private sector development in Eastern Europe, including the establishment of Enterprise Funds for Poland and Hungary under the SEED Act.

Under U.S. leadership, multilateral institutions are also engaged in helping the region. Both the International Monetary Fund (IMF) and the World Bank are actively supporting economic reform in Poland and other countries that are members of the Fund and Bank: Hungary, Romania, and Yugoslavia. The magnitude of this support is impressive. The IMF has committed more than $1.5 billion under stand-by arrangements with Poland, Yugoslavia, and Hungary. The World Bank is extending project and non-project loans to these three countries at the rate of almost $2 billion per year. Recognizing the key role played by these institutions, Czechoslovakia and Bulgaria have recently applied to become members.

European Bank for Reconstruction and Development

A new institution positioned to provide significant funds for Eastern Europe is the European Bank for Reconstruction and Development (EBRD). The Bank is the response of the Western countries to demonstrate their political and economic commitment to and solidarity with the Eastern European countries that had decided to undertake the transition to multi-party democracy and market-oriented economies. The Bank is also viewed as a vehicle which could, through its borrowing in capital markets, leverage contributed funds into larger loanable resources to support much needed economic reforms in these Eastern European countries. This "leveraging" will enable the EBRD to lend about $12 billion in support of Eastern Europe at a total budgetary cost to the United States of only $350 million over the next five years. The U.S. share of the Bank's $12 billion capitalization will be 10 percent, making the United States the largest shareholder.

The United States supported the concept of a multilateral Bank that would facilitate the transition of the borrowing countries to democracy and pluralism and a market-oriented economy. We saw a development bank for Eastern Europe as a unique institution and insisted that these concepts be an integral part of the EBRD's charter. This the first time these principles have been included in a development bank charter.

The charter of the EBRD also requires that at least 60 percent of the EBRD's aggregate annual lending and its lending by country for the first five years be to the private sector or state-owned enterprises that are shifting to private ownership and control.

While the Soviet Union is eligible to be a borrowing member of the EBRD, its borrowing will be limited for a three-year period to the amount of their paid-in subscriptions to the Bank and will be confined to loans for the private sector or to help enterprises operating competitively and moving to a market orientation. Any expansion of Soviet borrowing after the three-year period will require agreement by members holding 85 percent of the voting power.

Technical Assistance

Our technical assistance to Eastern European countries is likely to be more important in the long run, however, than our financial assistance. These countries need technical assistance in virtually every sector of their economies. For example, they need help in setting up business schools to teach enterprise managers how to operate in a market economy. They need foreign expertise to set up effective farm credit programs, and to establish a legal framework for private ownership of property.

The importance of technical assistance has been recognized by the United States and other Western countries, and is reflected in last year's SEED Act and the Administration's proposal for assistance to Eastern Europe in FY 1991. As part of the overall interagency coordination of economic policy with Eastern Europe, a wide-ranging program of technical assistance to Eastern European countries has been developed. We in the Treasury are giving particular attention to financial sector reform, and we are chairing an interagency task force to guide our efforts in this area.

Trade and Investment

The United States has entered into discussions with Eastern European countries aimed at reaching agreements to improve trade, business, and investment conditions. The investment discussions are intended to result in treaties or agreements that include provisions for stable, market-oriented policies towards foreign investment, free transfers of capital and returns on investment, fair dispute settlement procedures, and discipline over the use of performance requirements.

The first treaty, a business and economic relations treaty with Poland, was signed last month. It will be submitted to the Senate for approval in the near future. This treaty goes beyond the areas in our model bilateral investment treaty by extending protection to commercial activities, such as representative offices of U.S. companies seeking sales in Poland. The treaty also includes important commitments by Poland with regard to the protection of intellectual property, expropriation, and investment screening.

We had preliminary discussions with Hungary on investment issues prior to its recent elections. We will propose negotiating with the new government a business and economic relations agreement similar to that recently concluded with Poland.

— Last week, we signed a trade agreement with Czechoslovakia that mutually applies GATT rules on trade, provides for protection of intellectual property, and guarantees non-discriminatory treatment in access to currency and banking accounts. Our investment treaty discussions with Czechoslovakia are underway, but are not near agreement.

Tax Treaties

We have income tax treaties currently in effect with some Eastern European countries, and we hope to begin negotiations soon on treaties with others.

These treaties form an important economic link with Eastern Europe, as with other countries, because they facilitate bilateral investment flows and business opportunities. Specifically, such treaties reciprocally raise the thresholds of business activity necessary for a foreign country's income tax system to apply. They also reduce foreign taxes on investment income, such as dividends, interest and royalties earned by U.S. residents. In addition, and often of equal importance, the treaties provide for the elimination of double taxation, through a reciprocal guarantee of a foreign tax credit or similar mechanism and through harmonizing technical rules. Finally, treaties establish a government-to-government tax dispute resolution system to which taxpayers can turn.

By undertaking treaty negotiations promptly with the countries of Eastern Europe where treaties do not now exist or need revision, we will make it more attractive for U.S. investors to enter those markets. Other industrial countries, such as France, Germany, Japan, and the United Kingdom have been concluding modern tax treaties with Eastern Europe. We want U.S. investors to operate under conditions no less favorable.

We have income tax treaties with Romania, Poland, and Hungary. These have been in effect for more than a decade, and are close to our model and the OECD model for income tax treaties. They have stood the test of time fairly well. In the restructuring of their economies, Eastern European countries may enact new laws, or modify existing laws, in such a way that revision of the tax treaties becomes necessary. Because the treaties are close to our model, however, many changes toward a more typical income tax system by these countries will be adequately accommodated by the existing treaties.

We expect to meet with representatives of Bulgaria later this spring to begin negotiations. We hope to begin similar talks with Czechoslovakia soon thereafter, and to resume negotiations with Yugoslavia once their tax reforms are completed. Treaty issues with East Germany depend on the progress and nature of unification with the Federal Republic of Germany.

EUROPEAN COMMUNITY

The United States strongly supports European economic integration. The reinvigoration of the EC's efforts towards the eventual goal of economic and monetary union has significant implications for the United States and world economy. Treasury has followed closely the full range of issues with a focus on financial and investment issues.

Banking and Finance

The EC's plan to liberalize European financial markets would essentially create a single EC capital market and banking systems that permit universal banking. It takes steps towards mutual recognition of EC national financial supervisory systems. These changes would lead to more efficient and competitive capital markets and a more efficient allocation of capital, providing benefits throughout the EC economy.

We have worked with our EC colleagues engaged in preparing EC banking and securities directives to take effect January 1, 1993. Early in the process it appeared possible that the banking directive and investment services directive would contain strict reciprocity provisions which could damage U.S. interests. The EC subsequently revised the directives, substantially alleviating our concerns.

Investment

The Administration is reviewing the investment implications of EC 1992. Our tentative conclusion is that the EC 1992 rules on mergers and acquisitions will enhance U.S. investment opportunities. However, the manner in which the EC implements the new rules will be the determining factor. We will monitor implementation closely.

We also are monitoring developments to assure that national treatment of foreign-owned firms in the EC is not abridged by the process of creating a single market. We anticipate that U.S.-owned subsidiaries will be treated as EC-country companies for all purposes within the single European market, just as we accord EC and other foreign-owned companies national treatment in the United States. We expect the same treatment of U.S. companies within the EC.

Taxes

With regard to taxes, we are closely following tax issues associated with EC 1992. The pace of harmonization in the area of taxation, particularly income taxation, is slow. This is to be expected, considering that the EC member states have strongly held and diverse views on tax issues, and that EC tax directives require unanimous consent. In many cases, EC members have a system of bilateral tax treaties with other EC members that resolve many conflicts.

In July of this year, remaining capital controls within the Community will be removed by most EC countries. Some EC member states and the EC Commission have been concerned about the effect of free capital movement on their tax revenues. We have had informal and preliminary talks about a multilateral response to these difficult issues.

Within the EC, authority in the area of taxation is retained by each individual state. The member states have not developed a multilateral tax treaty for use with the rest of the world. Therefore, the United States will continue its current policy of negotiating and concluding income tax treaties with individual states. A single tax treaty between the United States and the EC is not a realistic possibility in the foreseeable future.

Monitoring Developments

The financial, monetary, and tax issues relating to EC economic integration will be of paramount importance. Therefore, I established an Economic Policy Council (EPC) Policy Group on European Monetary Reform and Financial Liberalization with participation from the key economic agencies and relevant financial regulators. This group will report to the EPC on the macroeconomic and financial implications of economic and monetary union.

The Treasury is currently coordinating a National Treatment Study on financial services. This study, mandated by the 1988 Trade Act, is due this December. It will be more extensive than any previously prepared.

FOREIGN INVESTMENT

We welcome foreign direct investment and encourage other countries to do likewise. U.S. policy is based on the conviction that when capital is free to flow to its most efficient use, the results are greater productivity and enhanced international competitiveness.

The benefits of an open investment policy are not just a matter of economic theory; they are tangible. Foreign direct investment provides benefits in the forms of advanced technology, new management skills, jobs, and larger payrolls. These are important at the national level in terms of the overall health of this economy, as well as at the factory gate.

At at time of relatively low domestic savings, foreign investment helps us maintain high levels of investment which is so important to our economic performance. A major goal of the Administration is to improve national savings and domestic capital formation.

Foreign Investment and National Security

The United States has consistently provided foreign investors non-discriminatory treatment as a matter of law and practice. We maintain exceptions to such treatment only as necessary to protect national security.

The 1988 Trade Act included the Exon-Florio provision which empowers the President to investigate and to prohibit or suspend foreign acquisitions that threaten to impair the national security. The President delegated his authority to investigate transactions to the Committee on Foreign Investment in the United States (CFIUS), an interagency committee which I chair.

The Committee will continue to implement the Exon-Florio provision to fulfill its spirit and intent. This will be done within the context of a continued commitment to an open investment policy.

TAX POLICY ON INBOUND INVESTMENT

Our tax policy toward foreign investment in the United States is to tax foreign investors fairly, reasonably, and in accordance with international norms that reduce tax barriers to international transactions. While we must continue to monitor new developments, we believe in general that our tax policy toward foreign investment is sound and effectively serves the United States' best interests.

Tax Treaties

In discussing the United States' overall policy on foreign investment, it is important to note that U.S. investors own extremely large amounts of foreign assets. Thus, the decisions we make about foreign investment in the United States will affect the large volume of U.S. investment abroad.

To promote bilateral trade, investment and cultural relations, we have entered into a broad network of tax treaties. These treaties conform substantially to standards well-established in the international community. The value of this treaty network to U.S. businesses and investors is discussed above in my remarks on Eastern Europe. This network helps U.S. businesses and U.S. investors achieve the same "open door" that we are willing to offer foreign subsidiaries here, both through treaties and domestic legislation.

Taxes on Investment Income

An important aspect of our tax policy toward international investment is that investment income generally should be subject to a relatively low tax rate in the country where the income has its source. This principle is reflected primarily in our income tax treaties, but also in the Code for certain types of income, such as most types of interest income and gains from sales of securities.

Low withholding taxes promote a more efficient world-wide allocation of capital with respect to both foreign capital invested in the United States and U.S. capital invested abroad. Low withholding taxes on investment income is a good general policy because residence country taxation is often a more accurate means of determining, on a world-wide basis, the investor's overall income, expenses, gains, and losses. A policy of low withholding taxes on investment income does not, of course, dictate a zero level of withholding.

Taxes on Interest Income

An important issue concerning source country taxes on investment income that has received attention recently, both in Europe and in the United States, is the question of withholding taxes on interest income. The issue was debated in 1984, when Congress enacted the "portfolio interest" rules. These rules exempt from U.S. tax much of the interest paid from U.S. sources to unrelated foreign lenders. Treasury supported this legislation on the grounds that it would help to provide U.S. borrowers more efficient access to the Eurobond market, to lower domestic borrowing costs, and to promote valuable capital inflows directly to the United States. Thereby, it would contribute to capital formation and substantial economic growth in the United States. We continue to support these rules.

Questions have nevertheless persisted about the proper general treatment of interest payments to foreign investors. These questions relate to concerns about revenue, as well as capital flight and tax evasion. There are no simple answers to these questions. However, we believe that issues such as these are best addressed through multilateral discussions. We believe, in general, multilateral agreements offer the best hope for solutions to many difficult international tax problems.

Overriding Tax Treaties

Finally, I would like to address what internationally may be the single most controversial issue concerning U.S. tax policy toward foreign investors -- the increased willingness of Congress in recent years to override our treaty obligations.

Although we are encouraged by recent developments, particularly the willingness of the Congress to improve the treaty posture of the "earnings stripping" provision in last year's Reconciliation Bill, we continue to be concerned. Treaty overrides have resulted in threats of retaliation and, more tangibly, in the clear prospect of less desirable outcomes for the United States in recent treaty negotiations. Foreign negotiators insist on greater concessions from us than would otherwise be fair or balanced when they are uncertain whether or not our side of the bargain will be kept.

I believe the solution to this problem lies in regular consultation with Congress. Such consultations should assure that legitimate legislative goals will not be frustrated by a rigid or antiquated tax treaty program, while at the same time permitting our treaty program to continue to meet changing conditions and needs.

Chairman **Rostenkowski**. Thank you, Mr. Secretary.

Mr. Secretary, witnesses in earlier hearings have urged this committee to act now to make changes in the Tax Code in order to avoid putting U.S. companies at a serious disadvantage in an integrated European market.

Do you feel that we should make these changes in U.S. tax policy now to reflect the new competitive world in which we live?

Secretary **Brady**. Well, Mr. Chairman, I do believe that we are in a new competitive world. But I see at this moment that American industry is holding its own. So I think that although we have got to manage and work on certain details that the way things are right now is working in our favor.

Chairman **Rostenkowski**. Sam.

Mr. **Gibbons**. I am a little surprised. The last time I read it, Mr. Secretary, we still had about a hundred billion dollar trade deficit. I know it got a little better last month, but we're piling up a huge, huge foreign indebtedness that has got to come out of something somewhere. I think a part of the problem is our tax system.

As I analyze it, goods coming into this country from abroad carry with them little or no cost of Government, and because of our tax system, we add nothing to it before it goes to retail, little or nothing to it.

But when we manufacture something in this country, under our tax system, it goes out of this country with the full cost of the U.S. Government on it. When it gets to their country, they add their cost of government to it. So our goods are competing against goods that sell in this country with no cost of government versus our cost and their cost for our goods.

I don't see how we have done as well as we have. And I am really surprised to hear you say that we are doing all right. I can't understand it in light of the huge cumulative trade deficit we have run up.

Secretary **Brady**. Well, Congressman Gibbons, I share your concern with the size of our trade deficit. But I would point out that it has come down in the last 2 or 3 years from roughly $150 to $100 billion. This most recent month decrease that lowered the monthly deficit to about $6 billion may very well be an aberration. It could be that it will jump back up again.

But I firmly believe that once our currency stabilizes, at approximately the level where it has been for in the last several years, American industry will gear back up again. It takes time for them to put in place their sales and manufacturing facilities to compete with businesses abroad. When this happens, the deficit will continue to move down, although not at a rate that we should be particularly proud of.

Mr. **Gibbons**. Well, I am glad that it is coming down, but when I look at the cumulative deficit, it is horrendous and it is a burden upon the future wealth of this country.

Now, Mr. Secretary, I hope that you and your department will study the problem that the United States faces. At one time, the economists told us that all these things were wiped out at the border because of the value of currencies. But that does not work any more. The value of currencies apparently is set more by the financial markets than by the trade markets. And our goods are carrying our cost of government plus their cost to government to retail their goods in our markets are carrying no cost of government to retail. We cannot compete on that basis.

Now, what further concerns me is that as I look at our foreign tax policy on U.S. businesses, it appears to me that we are making it almost impossible for U.S. concerns to do any business abroad. And we have got to have business abroad or we cannot make our sales.

Further, considering the fact that in order to sell the manufactured goods that we manufacture in this country, now we have got to export 20 percent of them; and to sell our agricultural products, we have got to export 35 percent of them, we cannot go on maintaining the same standard of living, the same level of employment that we currently enjoy.

I don't know how our farms and factories and labor have done so well under the tax system that we so worship but works so against us. I wish you all would look at that and study it.

If I am wrong, I want you to correct me, but I don't receive from the business community or from the administration any suggestion that I am wrong. Our goods cannot go on carrying the burden that they carry and still be sold at competitive prices abroad.

Chairman ROSTENKOWSKI. Mr. Schulze.

Mr. SCHULZE. Thank you, Mr. Chairman.

Welcome, Mr. Secretary. It is always a pleasure to have you and have your advice.

As we go into "Europe 92," and we look at the Uruguay round, and we look at what is happening, I realize your concern about treaty overrides. But along with treaty overrides, the topic and the Uruguay round, of course, this committee gets the first bite of the apple on the ratification of the Uruguay round.

And I wonder if you are keeping a close eye on what is going on with that, and whether you are satisfied at the progress of the Uruguay round as it relates to your area so that when we do get our first bite at it, we don't come up with a lot of surprises.

When we talk about treaty override, I realize that we also have had that problem in the Caribbean in the immediate past, and that is of some concern. So I would think it would be a major embarrassment if we were unable to ratify the Uruguay round agreement, and just want to know whether you were keeping an eye—you and your staff were keeping an eye on there, whether things are going as you would like them to go?

Secretary BRADY. Congressman Schulze, I think that you know that the Treasury Department does work very closely with USTR and the other members of the team that works on the Uruguay round.

Like all things, it is a combination of good news and bad news, and I think we are making good progress on financial services, really good progress. In the area of agriculture, which is enormously important to the EC—I think it's some 40 percent or 50 percent of their budget—progress has been pretty slow. We do have enormous pressure on the other members of the Uruguay round negotiations to try and do something about agriculture. But I would be less than frank to tell you differently. It is the one on which we spend the most time. I think this won't be any surprise, because I think this is well known to the committee, but I am not sure you will be particularly pleased with the progress. But we hope by the end of the year that you will be more satisfied.

Mr. **Schulze**. Good. As "Europe 92" emerges, and we are all aware of dynamism in Eastern Europe, I have a concern which has been a longstanding concern, and that is how we handle currencies that we don't really recognize that don't have a legitimate base.

I realize the business community is doing a lot with counter trade. I also have a great concern where countries are actually developing product lines in order to secure hard currency. And, in my opinion, this distorts the market somewhat.

And I wonder if you have any thoughts on that? I really have mixed emotions about counter trade where products are given an exchange, where the currency is not acceptable, and whether we ought to encourage and foster and continue that type of policy. And I just wanted to get your thoughts on it.

Secretary **Brady**. I would like to ask Charles Dallara, who has been handling this matter for the Treasury, to give you a precise answer to that.

Mr. **Dallara**. Thank you, Mr. Secretary.

Congressman Schulze, we agree with you that counter trade is not a particularly efficient way to expand global trade, and it can in fact distort trade flows. We have taken the general view of discouraging such arrangements, although they are generally not prohibited under international trading arrangements.

Mr. **Schulze**. What are we going to do about currencies as "EC 92" comes about, as Eastern Europe starts making this metamorphosis from so-called nonmarket economies to market economies? How are we going to draw guidelines on currency? How would you like to see us do that, Mr. Secretary, or do we just sit back and wait till their currency is solid enough that we will say now we will accept it, or how should we handle that?

Secretary **Brady**. No. I don't think we should sit back and wait. Some of these transactions are ones that are important to trade, such as the Pepsi-Cola-vodka deal in Russia. Of course there are only a limited number of transactions that can take place because of the weakness of the ruble, but as we strive to bring the Soviet Union into the free-market economy, this is a first step, to have trade between two countries that are now trying to get trade started. So I think it is a mixed blessing.

Mr. **Schulze**. But when we subsidize inefficient nonmarket economy production which, in effect, we do when we buy it. We do deal through countertrade and legitimize the currency.

We are sort of subsidizing that half Socialist/half Communist/half market oriented in between type of economy which I don't think will work. And it gives me concern that we make people think that it works when it's half Socialist and half free. And should we say no, you have got to be 100 percent pure, or 90 percent? Is there a way we can tell when we should legitimize such a metamorphis?

Secretary **Brady**. I think you have given the answer to your own question, Congressman Schulze. In regard to the Soviet Union, there is no other way you are going to get products priced on the basis of a pricing system that is anywhere near what we recognize in market economies.

The same thing is going to be true in the Eastern bloc countries. If we are trying to encourage these countries to look to the market, we shouldn't, in the initial stages of that process, be too quick to knock down those products that they can get out of their own country. Showing people that at least there are some products that will work, products that other people want to buy.

So I think we shouldn't judge the results of the system too early in the game.

Mr. SCHULZE. Thank you, Mr. Secretary. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Cardin.

Mr. CARDIN. Thank you, Mr. Secretary. Mr. Secretary, it is a pleasure to have you before the committee.

I would like to explore the opportunities for American companies in Eastern Europe and the Soviet Union.

One of the trends that disturbs many of us is that we are now finding more foreign investment, direct investment to the United States than direct investment by Americans abroad. And Europe, Eastern Europe appears to offer some immediate opportunities for American companies, along with the Soviet Union.

I am wondering whether you have a priority list of the reforms that we are seeking in Eastern Europe that will assist American companies in being more bold in their investment opportunities there?

Secretary BRADY. Your question is whether there is some system that will take our companies and get them——

Mr. CARDIN. What reforms do you think are necessary in Eastern Europe for American companies to have a better chance to take advantage of those opportunities?

Secretary BRADY. Well, in the Soviet Union, you obviously have to start from scratch. They have no pricing system, they have no sense of private property, no private banking system.

In the Eastern bloc, it is a little better than that. But depending on which country you are in, they still show the effects of 40 years of domination by the Soviet Union and command societies.

I think that the first thing we have to do is to establish the notion of profit and private ownership, and a pricing system that allows people to really judge whether they are making a profit or not, instead of just producing because there is a production goal set.

I would say one more thing, Congressman Cardin. When you talked about the investment in the United States by overseas sources, be it Japan, Germany, or the like, I think we have to recognize that their direct investments in our country are more recent than ours in their country. If you put all of this direct investment in both directions at market value, you would see that the value of the United States direct investment abroad may be as much as double what is in the United States.

The statistics we have are as good as you can do, but they are a little misleading.

Mr. CARDIN. That the trend is somewhat disturbing. Let me talk about currency reform. We talked about the fully convertible currency issues. Obviously that is a matter of major concern as to how currency reform is taking place in the Soviet Union and Europe.

How rapidly could we expect to see currency reform in these nations? What type of time schedule is reasonable here?

Secretary **Brady**. I cannot give you a time schedule, and I am not trying to be evasive. As we get into the negotiations with each of these countries in the Eastern bloc, it becomes clear that there is a long way to go. About all we can do is to try to be helpful. For example, the United States Treasury was a leader in putting together a $1 billion stabilization fund for Poland. I might note that because of the directness and ferocity with which the Poles have attacked the problem, the fund has not been drawn down yet, so that is quite encouraging.

But there is not a time schedule that we can put forward and be confident that it is going to be something that you could look at 1 month or 2 later, or even 6 months later and be sure of. I think what we have got to do is to aim the ship. We know pretty much what has to be done, but it is a question of how rapidly these countries are able to take steps leading toward a market economy.

Mr. **Cardin**. Have we looked at the effect of German reunification? Assuming that there is some arrangement worked out with the East German mark and the West German mark, what impact that could have on the West German mark; has that been analyzed by Treasury?

Secretary **Brady**. We have, but we have to use the statistics and information that are given to us by the West German Government, as does everybody else. The West German Government feels that the reunification process can take place, and not cause a major dislocation either in their own country or the EC.

We will just have to wait and see. There are those who say the deal they are offering the East Germans with regard to the mark cannot possibly be accomplished without inciting inflation. The West Germans, on the other hand, say that, because East German labor will be cheaper, it can be done without inflation.

My guess is it is going to be a little more difficult than the West Germans say or think it is going to be, but probably will not cause a major blip in EC affairs.

Mr. **Cardin**. Thank you, Mr. Secretary.

Mr. **Rangel** [presiding]. Mr. Andrews.

Mr. **Andrews**. Mr. Secretary, just to follow up for a second on the questions by Mr. Gibbons earlier, I wonder if you would tell us what the two or three primary causes, in your personal opinion, of the fact that we have now gone from being the largest creditor nation in the world to the largest debtor nation, in a relatively short time in our history?

Also what specific suggestions would you make to the committee of what the Congress should do this year and next year to remedy the situation and what steps you think the administration should take?

Secretary **Brady**. Let me first of all say that the trade imbalance that we have had, obviously started with the enormous difference in wage rates. I can remember when the cost of manufacturing in Germany was a quarter of what it was in the United States. Now, it has pretty much come into parity. And in Japan the same thing has happened, although part of the slack and difference in wage rates has been picked up in Korea and Taiwan and other developing nations. So that certainly is one factor.

Second, I would have to say a certain sense of complacency in the United States with regard to our own manufacturing prowess and practices that I think has been corrected in the last 4 or 5 years. It has been demonstrated to leaders in industry in this country that they are in a battle, and now they are doing something about it.

Mr. ANDREWS. How so? What are they doing? Give me an example.

Secretary BRADY. I think that if you look at the employment roll of almost any major manufacturing company in the United States, you will see that the work force is down and that efficiency has increased. These people have been relocated in other jobs in our society. All of this is an important process.

We should not look at those statistics and think that only people on production lines are being put out of work and are relocated. What has really happened is that the layers of management between the top people in a corporation and the workers on the floor have been completely overhauled. And that is important because the chain of command has been shortened.

Mr. ANDREWS. What specific steps do you think the Congress should take?

Secretary BRADY. The most important step of all, of course, is one that has to be taken by the Congress and the administration—the reduction of the budget deficit.

Although I would be glad to give you my ideas, you know pretty much what they are. I think we have to work on the spending side of the ledger. We have to take the revenues that are coming into Washington, DC, which are some $900 billion a year, and make sure that they are spread over the programs that we think are important.

Mr. ANDREWS. Are there some specific suggestions that you think the Administration should step forward and do on its own initiative, apart from some kind of compromise on the budget deficit?

Secretary BRADY. The President has put his budget out, I think it was on the 29th of January this year, and it is a book that is way too long for all of us. But it has got any number of initiatives, in education, the environment, and proposals for cuts in the defense which may or may not be enough. I would say that until we get some countersuggestions from Congress we ought to stay about where we are.

Mr. ANDREWS. Thank you, Mr. Chairman.

Mr. RANGEL. Mr. Archer.

Mr. ARCHER. Thank you, Mr. Chairman.

Mr. Secretary, again, welcome to our committee.

I would like to follow up just a little bit on this foreign source income taxation that we levy under our Tax Code. It is perhaps the most arcane area of the Tax Code and it was given little shrift in the 1986 Tax Reform Act. And the main concerns seem to be then that we had to attempt to harmonize the way that we taxed foreign source income to the way that we taxed domestic income, with, as I saw it, no regard to what that did to our competitiveness.

And now, Mr. Gibbons has articulated what I think is something that this country should consider and that is that we need to consider what are other foreign countries doing in the way that they tax and look to some degree to that.

And I am curious as to whether the Treasury believes today, as it did in 1986, that the only concern about foreign source income taxation was to harmonize it with the way that we tax domestic income, or whether you are now prepared to say that we should be concerned about harmonizing it with the way that our foreign competitors tax foreign source income.

Secretary **BRADY**. Congressman, I would like to call on Ken Gideon, the Assistant Secretary for Tax Policy to speak to that question.

Mr. **GIDEON**. Mr. Archer, we have been quite concerned about competitiveness issues as well. That is a major reason that the administration has put forward the capital gains proposal, the comparison to other industrialized countries.

Moving to the narrower issue that you raised, I think that it always requires a balance approach. We continue to look at specific proposals carefully when people bring them to us and tell us that they have competitive concerns that perhaps are in conflict with tax policy concerns.

Without further specificity, I do not know what I might say further to you on that.

Mr. **ARCHER**. Well, it seems clear to me that one of the sources for the sale of our products is to have American presence overseas that is familiar with our products that will order them, rather than order a product made in another country. One of the facets of that to me is in the area of section 911 and I wonder if the Treasury has a position as to whether we should expand the coverage under Section 911 to make it more attractive to employ Americans overseas rather than employing foreigners, who are not taxed on their overseas earnings.

Mr. **GIDEON**. I think that would require careful consideration. I think that there are a number of problems with a significant expansion of section 911 first of course would be its budgetary cost at a time when we are trying to balance, to meet the Gramm-Rudman goals with respect to the budget. Second, I think that it is a fairly generous exclusion as it stands. To expand it significantly is a problem.

Mr. **ARCHER**. Well, one last question if I may, Mr. Secretary?

We understand that some 30 of our States are now aggressively pursuing the Japanese in an effort to encourage them to make investments in their home States, here in the United States, by giving them waivers of taxation, tax holidays, et cetera. That, in effect, reduces the tax base for this country, albeit in the State arena rather than the Federal arena.

And I am wondering if you feel that the Federal Government should in any way intervene in this to discourage such an activity as detrimental to overall U.S. economic interests, work with the States to ensure that when such incentives are offered that reciprocal benefits are extracted from the Japanese or should you feel that the Federal Government should just not get involved in that at all?

Secretary **Brady**. Congressman Archer, I think that the studies that we have seen indicate that the final decision as to where to locate plants among the bidding States generally does not come down to being determined by the tax incentives. There are location for facilities, wage rates in the particular area, and the like.

But having said that, the so-called bidding among States does not make sense the way that we look at it. Bidding among States using incentives that are paid for by the taxpayers is not something we think is a great idea.

Mr. **Archer**. You do not think it is a great idea, is that correct?

Secretary **Brady**. Yes.

Mr. **Archer**. OK, thank you, very much.

Mr. **Rangel**. Mr. Dorgan.

Mr. **Dorgan**. Thank you, Mr. Chairman.

Mr. Secretary, welcome.

I would like to ask about some statements that you made on page 8 of your testimony on——

Secretary **Brady**. Sorry, Congressman, I did not hear you.

Mr. **Dorgan**. On page 8 of your testimony, you have a discussion of taxes on interest income and I have been interested in that area for some while and I recall the debate in 1984. The withholding taxes on interest income were abandoned and I assume to promote capital inflows to the United States as you say. You indicate that there is concern about tax evasion and other related issues. Do we know at this point, what kind of nowhere income, or what kind of tax avoidance or tax evasion exists as a result of creating a climate in which foreigners can get income from this country without the requirement to pay taxes?

Secretary **Brady**. No; I do not think we do know and I will ask Mr. Gideon to comment if he thinks that statement is incorrect.

But what I do think is important is something that you put your finger on. In a time when we have been running budget deficits, we have no barriers to foreigners investing in the United States. It is a perfectly well known fact that the Japanese have been large buyers of our Government bonds. In one sense this could be alarming, but in another sense, compared to historical figures, it is still roughly in the 15- to 20-percent category—not the Japanese, but the total foreign holdings of United States Government securities. And so we do not see it as being out of line.

As to the specific issue of tax avoidance, I do not know of as any specific study that shows that.

Mr. **Dorgan**. But the premise here, I understand is, that if we required a foreigner, who moves capital to this country, to pay the same kind of taxes on the income that an American would pay, somehow they would be inclined not to invest here. Is that the premise here, Mr. Gideon?

Secretary **Brady**. I think that is the premise. And the foreign finance ministers that I have talked to feel the same way. This is an important avenue of finance for this country to keep open.

Mr. **Dorgan**. But you understand from a tax fairness question here, we, in effect, are using the Tax Code to subsidize the foreign investment in this country by saying, if you keep the money invested here, you do not have to pay taxes like everybody else has to pay it. That is why I was concerned about the elimination of the withholding. I know that Mr. Gibbons and I had some discussions about this back in the mid-1980's.

Mr. GIDEON. I would like to comment on that. American Treasury debt is registered debt. As a result, we know who owns it, and we report who owns it to foreign governments under exchange agreements. As a result, we do not think it is being used for purposes of evasion.

Typically, the situation is that we have the right to receive flows from those countries at a zero rate as well, the theory being that we would tax our nationals and they would tax their nationals.

As long as there are large flows in both directions, that may be the most efficient and fairest way to impose those taxes.

Mr. DORGAN. But is not the most likely result nowhere income in both countries? I mean Eurobond debt is not registered, is that not correct?

Mr. GIDEON. Much Eurobond debt is not registered.

Mr. DORGAN. And what is the effect of that from a tax standpoint if it is unregistered?

Mr. GIDEON. Well, I think there is a question whether it is fully taxed in all of those countries.

Mr. DORGAN. But I wonder if it is a serious question?

Mr. GIDEON. I think it is obvious that the Europeans are beginning to become sensitive to this, but they clearly have not been sensitive enough to take on the bearer issue head on. I think, as we said in the testimony, that what we would be interested in is multilateral arrangements in this area, because we think that they have the best chance of success.

If any one country tries to go it alone—look at the German experience of fairly recently—it is likely that that country standing alone will suffer.

Mr. DORGAN. I am glad I raised the question while Mr. Gibbons was out of the room. He feels very strongly about this subject on the other side of the issue. But I had almost forgotten about it. You have reminded me again of it, and I do think that we ought to start some discussions about the basic question of fairness here; what we are trying to accomplish and what we do in order to accomplish that in suggesting that we are willing to be a tax haven here for tax avoidance if you all want to invest in America?

Secretary BRADY. If I could, Congressman, I just want to mention one more factor.

I think back in the 1970's and 1980's, if an investor wanted to make what he considered the premium investment, he would invest in U.S. Government bonds. That is still the case, but as the other economies in the world, Japan and Germany particularly have gotten stronger, we have found ourselves to some extent in a competition, a world competition for money.

I think it was Chairman Greenspan who said that the principal factor on the horizon that we should keep our eye on is a world shortage of savings in terms of investment needs. That has been exacerbated by what has taken place in Eastern Europe. It may be the reason for some slight uptick in long-term interest rates that is taking place—the possibility that we are going to be capital short.

If we are capital short, we want to make very, very sure that we are addressing a major ill when we tackle the problem of bearer bonds, or Eurobonds. By putting up barriers in that area, we make it harder to invest in the United States and give Japan and Germany an advantage in the cost of capital that we are trying very hard to make sure does not exist.

Mr. **Dorgan**. No. I understand that issue. I am just curious whether there has been any study at all of how much this income is truly nowhere income, not attributed to the country of origin and not attributed to the country of the source of the income?

My sense is that we have created a tax advantage, that we understand, represents classic international tax avoidance and I am very troubled by doing that.

Mr. **Gideon**. But we have not done that, Mr. Dorgan. I think it is important to remember that we have registered debt here for Treasury obligations.

Mr. **Dorgan**. I understand, but do you understand as well with respect to the Eurobond market, which is why we did what we did in the mid-1980's, that is not registered debt and that creates the classic tax avoidance scheme.

Mr. **Pease** [presiding]. The gentleman's time has expired.

Mr. Sundquist.

Mr. **Sundquist**. No questions, Mr. Chairman.

Mr. **Pease**. Mr. Coyne.

Mr. **Coyne**. I have no questions, Mr. Chairman.

Mr. **Pease**. Mr. Anthony.

Mr. **Anthony**. Welcome, Mr. Secretary.

You mentioned the world competition for money and in your prepared text you talk about providing the flow of capital within the EC. My question is whether or not you see such enhanced flow of capital in this unified community as creating greater competition for our debt, be it corporate registered debt or government registered debt?

Secretary **Brady**. I think we have to be fair with ourselves when we analyze this problem. I think the development of the EC will mean a market with huge potential and corporations in it that are more resilient than they are now. We probably will be more in competition with the EC when it finally gets all of its wheels working and well greased. So that I think that might be a negative. The positive side is that this is going to be a tremendous market for our U.S. corporations that because of the amount of money that they have invested overseas for the last 40 or 50 years are well placed to take advantage of that market. So it is good and it is bad.

Mr. **Anthony**. Earlier today, Secretary Baker was here and I questioned him about the potential inflationary impact of some of the actions that were taking place in this unified European market. If there is competition, would that not drive up the interest rates in the United States, and therefore, have residual inflationary impact on our economy?

Secretary **Brady**. It may on the margin. Congressman Anthony, I think that there are people who feel that a rise in the long-term bond rate of roughly from 8.50 percent to 8.75 is a reflection of what people may see coming in terms of demand for investment in the Eastern bloc.

It has a particular coincidence, the rise in interest rates—it is not a big rise, from 8.50 to 8.75—you could almost plot it against the emergence of the new democracies we hope to see in Eastern Europe. So I think it will have some effect, but I do not see it as something that we will all be sitting around and worrying about. It is on the margin I think it may very well increase the demand for investment and put pressure on the pool of savings.

Mr. **Anthony**. In the final paragraph of your testimony, you indicated that you continue to be concerned about Congress intermingling and overriding some of your treaties on taxation of foreign investment in the United States.

With regard to our companies investing in foreign markets, do you believe similar problems exist among their governments?

Secretary **Brady**. I will ask Ken Gideon to comment on this. I think that the general principle we are trying to be guided by is that if we start a kind of tax war, the whole world economy will be the loser. The aim, as I know you understand, of the Uruguay round is to try and reduce impediments to world trade. So on the one hand, of course, we want to make sure that our corporations are fairly treated, and on the other hand we think that we will benefit as much or more than anybody by having an open trading system, and not starting a war of special taxes or special subsidies.

Mr. **Anthony**. Yet at the same time, Mr. Secretary, you indicate that the most difficult issue to resolve within the integrated community, will be their own tax laws, each country wants to maintain its own individual tax components.

Secretary **Brady**. The problem that we think will take the longest time to solve in the European Community is one that relates to the harmony of taxes within the EC. The progress in that regard has not been very rapid.

Mr. **Anthony**. So, Mr. Gideon, I would like your response to whether or not our private sector is running into similar types of impediments?

Mr. **Gideon**. Certainly with respect to overriding of treaties by the European countries, that virtually never happens. And I think it is one of the reasons why they express themselves so strongly to us with respect to overrides of treaties in this country.

Mr. **Anthony**. If you could, for the record, provide examples of those areas where you think treaty overrides have occurred. I would like to go over those examples.

Mr. **Gideon**. Examples of overrides?

Mr. **Anthony**. Yes; if you could.

Mr. **Gideon**. We would be happy to supply those.

Mr. **Anthony**. Thank you.

[The information follows:]

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

MAY 8 1990

The Honorable Beryl F. Anthony, Jr.
United States House of Representatives
Washington, D.C. 20515

Dear Mr. Anthony:

As I promised you during Secretary's Brady testimony before the Ways and Means Committee on April 18th, I have prepared the attached summary of the instances in which Congress has overridden provisions of income or estate tax treaty obligations between the United States and other countries.

I hope that you find this summary helpful.

Sincerely,

(Signed)

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

CONGRESSIONAL OVERRIDES OF U.S. TAX TREATY OBLIGATIONS

1. Revenue Act of 1962: The Act explicitly overrode any treaty provisions conflicting with the Act (Act § 31), but the legislative history stated Congress's understanding that the only actual conflict was with a minor provision of the U.S. - Greece Estate Tax Treaty, which Treasury had stated its intention to modify. It later developed that the new limitations on the foreign tax credit in the Act may have overridden provisions of certain income tax treaties then in effect, which entitled U.S. residents to the foreign tax credit rules in effect at the time these earlier treaties entered into force.

2. Tax Reform Act of 1976: The Act's legislative history stated that the revisions to the foreign tax credit rules were intended to apply notwithstanding any contrary treaty provision.

3. Foreign Investment in Real Property Tax Act of 1980: The Act subjected foreign investors to tax on dispositions of U.S. real property interests in circumstances where tax had not previously been owed. The Act explicitly overrode any contrary treaty provision, with a 5-7 year transition period during which treaty exemptions would be respected. Act § 1125(c)(1), (2).

4. Tax Reform Act of 1984:

    - The Act enacted the "stapled stock" rule of I.R.C. § 269B, which states that it shall apply notwithstanding any contrary treaty provision. The legislative history stated that this override would not apply to certain "grandfathered" arrangements.

    - The Act revised the accumulated earnings tax rules in I.R.C. §§ 532, 535. Although neither the Act nor its legislative history referred to an override, the legislative history of the 1986 Tax Reform Act stated that the 1984 provision overrode the U.S. - Jamaica income tax treaty.

5. Tax Reform Act of 1986: The Act substantially revised the U.S. tax rules governing international transactions. In the Technical and Miscellaneous Revenue Act of 1988 (discussed separately below), Congress revisited the relationship between treaties and the 1986 Act, and stated that a number of 1986 provisions either were or were not intended to override treaties.

    - The Act amended I.R.C. § 904(g), which ensures that certain U.S. source income retains its U.S. source even when received through a foreign corporation. The Act stated that section 904(g), originally enacted in 1984, was intended to override not only existing treaties, but also future treaties that do not explicitly state an intention to reverse the rule in section 904(g). Act § 1810(a)(4).

- The Act amended the source-of-income rules for sales of personal property by adding I.R.C. § 865. The General Explanation indicated that an override was intended. The Technical and Miscellaneous Revenue Act of 1988 clarified this by stating that no override was intended in certain respects (definition of "residence" for individuals, and certain sales of inventory by nonresidents) (1988 Act § 1012(aa)(3(A)).

- The Act added I.R.C. § 884 to provide for the new branch profits and branch interest taxes. Section 884(e) and the legislative history state that, although both taxes yield to applicable treaty obligations if the taxpayer is a "qualified resident" of the treaty country, the taxes override treaty obligations if the taxpayer is not a "qualified resident." (Note that a similar override provision is contained in the foreign stock sale rule of H.R. 4308, introduced on March 20, 1990.)

- The Act limited use of the foreign tax credit for alternative minimum tax purposes to 90% of the credit that otherwise would have been available. I.R.C. § 59(a). The 1988 Act stated that this provision overrides treaties (1988 Act § 1012(aa)(2)(B)).

- The Act revised the "baskets" used for determining the limitations on the foreign tax credit under § 904(d). The 1988 Act stated that these provisions override treaties (1988 Act § 1012(aa)(2)(A)).

- The Act revised the sourcing rule for transportation income. I.R.C. § 863(c)(2). The 1988 Act stated that this change was not intended to override treaties, except to the extent that the sourcing rule affects the computation of the foreign tax credit (1988 Act § 1012(aa)(3)(B)).

- The Act revised the sourcing rule for dividends and interest paid by companies deriving more than 80 percent of their income from foreign sources (so-called "80-20 corporations"). I.R.C. §§ 861, 871, 881. The 1988 Act stated that no override was intended, except to the extent that the sourcing issue is relevant to the computation of the foreign tax credit (1988 Act § 1012(aa)(3)(D)).

6. Technical and Miscellaneous Revenue Act of 1988: The Act overrode the insurance excise tax exemption in the U.S. - Barbados income tax treaty, but only with respect to premiums allocable to insurance coverage for periods after December 31, 1989. Act § 6139.

7. Omnibus Budget Reconciliation Act of 1989: The Act revised certain estate tax provisions of the 1988 Act affecting the marital deduction for decedents with alien surviving spouses. The result is that the 1988 Act will override certain provisions of the U.S. - Germany and U.S. - France estate tax treaties, but only after a three-year period beginning with enactment of the 1989 Act. 1989 Act § 7815(d)(14).

Mr. **Pease**. The gentleman's time has expired.

Mr. Crane.

Mr. **Crane**. Thank you, Mr. Chairman.

Welcome again, Mr. Secretary.

Our colleague from California who has a distinguished background in economics, and in fact, was a former professor out there, Tom Campbell, introduced legislation I am sure you are familiar with that would require equal access for foreign investment in a foreign country to the degree that we permit them to invest in this country. And, frankly, I find his legislation troublesome, but I would like to hear from an expert such as yourself.

Would such legislation be administratively feasible and secondly, would it be consistent with other international obligations we have? And thirdly, what would be the economic impact in your estimation on the United States? And I am thinking specifically of job creation on the one hand, and interest rates on the other.

Secretary **Brady**. Well, Congressman, as I think you know, we oppose the thrust of the Campbell bill. We support its objective of promoting national treatment, but the way that this particular bill goes at it, we feel, is not the way that we should proceed, and we think it will have, as you suggest, some effect on jobs and some effect on interest rates.

Mr. **Crane**. How great an impact potentially if we got into stiffened backs on the part of some of our foreign trading partners, and there was any significant fall off in foreign investment here, what impact would you estimate that could have potentially on interest rates?

Secretary **Brady**. I cannot give you an exact figure. Obviously we have a world economy that is going along at a reasonably successful rate now. The impact could be lost in the general economic sense of well being.

However, if these regulations were brought into play at a time when we were having a downturn, then you would see it kicking in, in a fairly substantial way.

Mr. **Crane**. Well, I am glad to hear your statements because it echoes a concern that I registered with Mr. Campbell about his bill. And as I told him, in terms of international negotiations to at least have that out there with as many cosponsors as he has, you folks should, at the executive level, be able to say look at what those crazies are contemplating and please, give us greater access to your markets.

One other thing. Recently, last year, as a matter of fact, one of our Federal Reserve Board Governors told the Russians on the convertibility question that he thought it would be advisable for them to issue gold-backed bonds on the one hand and to make the ruble convertible into gold.

And the thought struck me that that would certainly restore confidence over night in the integrity of the ruble and make it an international medium of exchange. And since they are one of the three largest gold producers in the world, they have the resource capability to back that up.

My understanding is further that Allen Greenspan, before he became head of the Federal Reserve Board, had written a paper basically to that same effect, and I would like to know your views on that?

Secretary BRADY. First of all, there is no question that any currency—particularly one that has had sky-rocketing changes connected with it in terms of its basic value—that would be improved by being backed by gold.

But I do not think that this is the basic problem that the Soviet Union is facing now, Congressman Crane. The issues are much deeper. The problems they are having with their society are well known and have been spelled out in the press and I do not believe that having the ruble backed by gold will do the job. Frankly—I have not done this calculation—but I do not believe that there is enough gold in Russia to sufficiently back the currency in order to achieve the objectives.

So you have to fix the root causes of the problems in that society and go that way.

Mr. CRANE. Well, as you know, Mr. Secretary, one of our colleagues has introduced legislation here to issue gold-backed bonds and the assumption is that you could pay in gold at about a 2-percent rate instead of the current rates of financing debt.

And the Soviet productive capability certainly is there to issue gold-backed bonds in some degree, and thus reduce some of their debt burden. Do you think that would be a course for them to consider taking?

Secretary BRADY. I cannot argue with the contention that if you gold-back bonds, they are going to be salable by the Soviet Union, as opposed to the case now, where because of the problems that they have in their society, bonds would be very hard to market, if they would be marketable at all.

But I would only say that I think we are, to some extent, swatting at flies if we look at the Soviet Union's problems as being one of whether they can or cannot do that. They can. But fundamentally the things that they have to do are deep and drastic changes if they want to make the change to a market society.

Mr. CRANE. Thank you, Mr. Secretary.

Mr. PEASE. Mr. Secretary, in addition to being the acting chairman of the committee, I am also the next person on the list to ask questions, so I will take my 5 minutes now.

Like my colleagues, I appreciate your being here and appreciate your testimony. I want to talk a bit about currencies. The democratization of Eastern Europe and the unification of the European market presents U.S. exporters with new opportunities. At the same time, the value of the dollar has slowly crept upward during the past months, making U.S. products relatively less attractive in foreign markets.

In addition, the yen began to decline in value in the wake of the fall of the Tokyo Stock Market, making Japanese goods cheaper in foreign markets. It seems to me that these developments do not bode very well for our trade balance which was subject of an earlier discussion.

What, if anything, is the Treasury doing or do you think it should be doing to counteract these developments?

Secretary BRADY. I am sorry, I did not hear the end of your question.

Mr. **Pease**. Well, considering the fact that the Japanese currency is weakening and the United States currency is strengthening against not only the yen, but also other currencies, is that a source of concern to the Treasury considering our competitiveness?

Secretary **Brady**. I think it is. Whenever you have a trade deficit the size of the one we have, a decrease in another currencys' values with respect to our own has got to be a concern.

I would say that, with regard to currency markets, which are now very largely in the domain of international security and trade movements, there is not an awful lot that you could do to try to regulate them. However, the thing that I think that we should be concerned about and the thing that this Treasury is concerned about, is stability.

If you will look back 2 or 3 years you will see that the yen has gone up and it has gone down and up and down, but in fact, it is not very far from the level where it was 3 years ago.

The same thing is more or less true of the deutsche mark. So the thing that is most pleasing, the most and encouraging about currency markets is that they are stable. Because when they are stable, Congressman Pease, that allows businessmen to make plans. When businessmen make plans, they make investments. And when they make investments, jobs come on line and new products are created. Old products are manufactured at a lower price.

So I tend to think that we should be most concerned with stability. The yen has gone down in recent months—due to the fact that the Tokyo Stock Market has come down and people are selling Japanese securities and getting into other currencies—and that adjustment has to go through the international currency settlement system and produces the changes we have seen.

Mr. **Pease**. Well, Mr. Secretary, if I am not mistaken, the Yen has gone from about 130 to about 160 in a period of roughly a year. I do not know what range you have in mind as being a normal range. I would be interested to know if you think the current 160 yen to a dollar is about right, satisfactory from our point of view, and how much higher the Yen could go, or how much stronger the dollar could get before it would be outside of that range that you would think is a normal range of stability?

Secretary **Brady**. Well, Congressman, if you will excuse me, I prefer not to talk about ranges. It is a matter that we discuss at G-7 meetings. The system of discussion among G-7 participants has been very effective, and it has been effective to some extent by not publishing ranges.

But I will call your attention to the fact that if you go back further than 1 year, if you go back 2 or 3 years, both with respect to the deutsche mark and the yen, we have had relative stability.

Since 1985, or 1984, when we saw a tremendous fall in the value of the dollar, we have had almost a straight line right across. I think that that is most productive of trade and serves this country best in stability.

Mr. **Pease**. Mr. Secretary, one other thing. Mr. McGrath, this morning, mentioned the concerns of the Latin American nations that last year's developments in Eastern Europe will keep the American eyes focused east instead of south.

Many of these Latin nations are still plagued by huge external debts with both private and public banks. Last year, your international debt plan was well received by both the press and the Latin countries. It seems to me that the results have been rather limited. Can you give us an update on your own feelings about how the Brady plan is working, say, in relation to the 10 largest Third World debtor nations?

Secretary **BRADY**. I would take the opposite view, Congressman Pease. I do not think the result has been limited. We have had transactions—deals, if you will—with countries such as Mexico, Venezuela, Costa Rica, Morocco, and the Philippines. If we were to be able to consummate this year a transaction with Brazil, we would have dealt with 77 percent of the commercial bank debt which Third World countries have outstanding.

I think that is a pretty good record, starting from last March.

Mr. **PEASE**. My time has expired.

I will not press the issue.

Thank you, Mr. Secretary.

Secretary **BRADY**. Thank you Congressman Pease.

Chairman **ROSTENKOWSKI**. Mrs. Johnson.

Mrs. **JOHNSON**. Thank you, Mr. Chairman.

Welcome, Secretary Brady. Three quick questions, Mr. Secretary. The enterprise fund under the SEED Act in Poland seems to be getting off to a very, very slow start. I know you have recently appointed the American directors. My understanding is that Poland hasn't appointed the Polish members of the board to oversee this. But it is distressing to see this enterprise fund not yet able to support the development of small business in Poland. Would you comment?

Secretary **BRADY**. Let me make sure I have your question, Mrs. Johnson. Your question is whether the enterprise fund in Poland is off to a slow start.

Mrs. **JOHNSON**. Right, the enterprise fund under the SEED Act.

Secretary **BRADY**. Yes. Well, it probably may have been better if we had been able to go a little faster. On the other hand, I want to tell you that the clearance process here is pretty much the same as it is for getting people through the clearance process for the Congress. You have to have FBI clearance and all that sort of thing, and in the case of Poland, you have got to make sure that the chairman and the other members of that board don't have links with Poland which will prejudice their actions or be held up to charges of conflict as you go along. So I am sorry it wasn't a little faster, but the normal process that takes place when we ask people to come from the private sector into the public sector was at work here as well.

I think both the Polish and the Hungarian enterprise funds are under way. I understand that they have hired executive directors, general counsels, and that they are looking for office space. It is well on the way.

Mrs. **JOHNSON**. Thank you. Since I have a couple other things, I want to get on with those. I appreciated that your testimony does catch us up to date on the various treaties that you are working on with various countries. That is very helpful to us, and I am glad so many have moved forward.

But in the area of investment, you say that the EC 1992 rules on mergers and acquisitions will probably enhance our position. How do you feel about what they are doing in standards and those areas, their rules that will govern product standards and investigations of meeting standards and things like that? My fear is that they will set rules that are very different from ours, and that we do not have sufficient input into that process.

Mr. **Dallara**. Congresswoman Johnson, if I could perhaps respond briefly. That is a concern that we share as well, and as we develop various treaty relations with them—for example, the recent business and commercial agreement with Poland—we are making every effort to address these concerns to the extent that we can in treaty relations so as to avoid the establishment of standards that create problems for United States businesses.

Mrs. **Johnson**. Thank you. And my last question is: In terms of foreign investment, when we talk about foreign investment and net investment in the United States by foreigners and American investment in foreign countries, do our figures reflect the purchase price of those investments, or do they reflect the current value of those investments?

Secretary **Brady**. They reflect the book value of those investments, which would be the purchase price, historically referred to as "book value." If you took, as I mentioned earlier, the value of our direct investments abroad and compared them to the value of foreigners' direct investment in the United States, I think you would find that the market value of our investments abroad is probably double what the market value of investments by foreigners in the United States. On the other hand, the book value is about the same.

Mrs. **Johnson**. Thank you. I think that is a very important point, and in today's discussion about who is selling out to whom isn't clear to the general citizenry. It is one, therefore, I wanted to confirm in the record.

Thank you, Mr. Chairman. Thank you, Mr. Secretary.

Chairman **Rostenkowski**. Mr. Guarini?

Mr. **Guarini**. Thank you, Mr. Chairman.

Mr. Secretary, once again it is good to see you, and thank you for your testimony. I think everybody recognizes that this is a once-in-a-lifetime opportunity that we have with what is unfolding around the world. I have a sense of benign disengagement that the administration may have here in Washington. We give standing ovations to Lech Walesa and Mr. Havel. We watch Gorbachev fighting on many different fronts at one time. And the question is whether or not we are really retaining our leadership as a world great power, what our sense of history is.

Let me direct myself to the development bank for Eastern Europe. I have long applauded that. Now, one thing that is becoming increasingly apparent is that private banks are reluctant to put money into Eastern Europe. Poland is somewhat of a basket case. Czechoslovakia doesn't need as much help as some other countries as does Poland. There is a tremendous shock going from a communistic system to a free marketplace. Their debt is extraordinary. They have a tremendous distortion of their work force as a result of planned economy. There is question as to whether or not they can in the near future get into any kind of a convertible currency, and they are just not market oriented in any way whatsoever.

I am wondering what our private sector is doing—for instance, our banks. Are we doing anything to get the private sector and banks—and that is different than what the public sector is, which is a development bank—to aid these countries that need some help and to put investments there? Are they doing their fair share, the American banking system, along with the development bank? Why is there such a reluctance to put money there? And is it that the taxpayers here have to shoulder most of the risk? We have a great democracy, and we are kind of facing the situation where the Government has taken the lead, and private corporations in America are taking somewhat of a lead. But the private banking system seems to be reluctant. What is the President doing in regard to this?

Secretary BRADY. Well, Congressman Guarini, I don't think it is necessarily the case that our U.S. banks are not taking the lead in the Eastern bloc countries. I know one of our commercial banks has recently said they are going to open up some branches in Poland. But I think we have to be aware of the fact that because of geographic proximity, the Eastern bloc is going to be an area of investment which is probably better understood and more natural for the EC countries. In fact, if you look at the level of foreign debt in a country like Poland, you will see that the great preponderance of it—commercial debt, that is—comes from Germany, Austria, England, France, and the like. Even Japan has a lower posture there than it does worldwide.

I think it is a question of historical relationships. A lot of the banks in Europe had branches in these countries before their takeover by the Soviet Union, so it is natural that they will go back first. One other factor that may affect the slowness of investment is the pressure we have had on the commercial banks to rationalize their investments in the Third World countries. By that I mean write down their investments in Mexico, Venezuela, Costa Rica, Morocco, wherever. I think all commercial banks are moving a little slower than they were before so that they will not rush in before they know exactly what they are getting into.

I don't think in the long run the American banking system is going to be unmindful of the opportunities in the Eastern bloc, but right now, after a rash of writeoffs in the Third World, I am not sure that they are going to be rushing in to make investments at this time. I would only say one more time that for banks in Germany, Austria, France, and England, it is a much more natural investment than it is for the United States commercial banks.

Mr. GUARINI. But there is a role for the private banks in the United States. Do you expect there will be significant progress? Do you think that the President may use some jawbonings in order to get the banks off the dime where the private sector can, through the banking industry, help investments to be nurtured in Eastern Europe?

Secretary BRADY. I can't tell you, Congressman, that our jawboning record with commercial banks is particularly successful. You know as well as I that, they are free to do what they want, and I think that they will be willing investors in the Eastern bloc when they see the opportunities there that should be backed by bank loans. So I think it is a hard question to answer.

Mr. **Guarini**. I wish you well, and good luck to you. Thank you.

Chairman **Rostenkowski**. Any further questions? Mr. Levin.

Mr. **Levin**. Thank you, Mr. Chairman.

Welcome, Mr. Secretary. Three questions arising out of your testimony. First, on the valuation of our currency, do you think today, taking into account our national and international needs, the dollar is overvalued as to the yen?

Secretary **Brady**. Well, Congressman Levin, as I said to Congressman Pease, the thing that I think is extraordinarily important is that we have stability in currency markets. Where people get nervous and pull in their horns is when you get wild fluctuations. And I think we have been very successful in the last 2 or 3 years at keeping currency markets stable, and that is important.

Commenting on something that can be as volatile as currency markets just doesn't do any good. I leave that to others, frankly. I don't mean you, but other people around the world who are brave enough to step into that particular game. I don't think it helps an awful lot.

Mr. **Levin**. But then let me ask you this, and then I want to get to at least one other question. What do you make of the argument of an increasing number of economists from a variety of perspectives that unless there is a further adjustment—and it has been going in the other direction—of the yen to the dollar that our trade deficit is going to remain over $100 billion for the foreseeable future?

Secretary **Brady**. I have always been on the other side of that question, which is that once the American business machine could get geared up—and it has—and saw markets abroad that they could make profits in, that our solid record of industrial efficiency would bring the trade deficit down. Although I wish it had come down faster than it has come down, from roughly 140, 150 to 100, I think that we will continue to see progress, although it won't be enormously fast progress. Obviously, if the yen-dollar relationship changes so that the dollar weakens against the yen, that will have some effect on it. But these effects tend to lag. I don't see any effect in the short run, and in the longer run, maybe 18 months, it will have an effect. There are those viewing the currency markets who feel that the current change in the dollar-yen relationship is a result of the decline in the Japanese stock market, and I think there is some sense to that view.

Mr. **Levin**. That is interesting, because your predecessor a number of years ago took the position that the main instrument in our entire artillery range was the currency valuation, and we were going to work to drive the dollar down. And now you are saying something quite different. But——

Secretary **Brady**. Could I interrupt you just for one more second? I think the other thing is that while the yen has weakened in favor of the dollar, that the dollar has weakened against the other currencies of the world at the same time. So although Japan is a big part of the trade problem, if the contention is made that a cheaper dollar is going to help the trade deficit, then the fact that the dollar has weakened against other currencies would tend to be helpful in that respect.

Mr. LEVIN. It seems to me that proves the argument. I don't quite understand. It proves that there is a problem with the present ratio. All right. Let me go on to a question where you and Mr. Baker, Secretary Baker, very much agree. Both of you in your testimony have referred to this natural advantage of Europe, Western Europe vis-a-vis Eastern Europe. And I think a lot of people hear that as an excuse rather than a good reason. For example, Japan is separated by a larger ocean than we are from Eastern Europe, but they have involved themselves in the American market actively. Is it really an adequate rationale or reason to say American banks aren't investing as actively as Western European banks in Eastern Europe because of this natural advantage? I mean, is that sending the right message to America to get with it, to get active? Aren't you sending the message Western Europe has this built-in advantage and we are always going to be second in terms of Eastern Europe?

Secretary BRADY. I do not think so. Let me just say I think we have to face the fact, Congressman, that geographic proximity has something to do with the level of bank loans that are made. If you take the level of bank loans to Latin America, you will find out that the United States has a much greater position than do the EC countries and Japan because, I believe, of geographic proximity and understanding of those countries' economies.

The same thing is true in reverse in the Eastern bloc. You take the same set of figures, and before anything happened in Eastern Europe, before any of the changes that we have seen took place, the level of investment by European banks in terms of loans was just the flip side of what ours was in Latin America. That is backed up by everything that I see at G-7 meetings, where because of the fact that you have got a border in between you and another country, trade goes back and forth. To facilitate that trade, bank loans are made.

We do not have the ability in this country to tell commercial banks, as you are well aware, where they should invest. However, we do have the ability to work with Congress and come forward with programs such as SEED 1 and 2, providing stabilization fund and venture funds for the Eastern bloc.

And so, I think that from a governmental point of view, both Congress and the United States are doing quite a lot. With regard to the bank loans, even if I was convinced that they should rush right in and do whatever they have to do, we did not do all that well with the commerical banks when we were trying to get the Latin American debt problem straightened out. They are free to do what they will and as they see fit. And I do not know how to change that.

Chairman ROSTENKOWSKI. Mrs. Johnson.

Mrs. JOHNSON. Thank you very much, Mr. Chairman.

This is not directly relevant to our hearing, Mr. Secretary. But as you are with us, I did want to remind you of my deep concern about the even-handedness of the bank regulator's actions in the Northeast relative to other parts of the Nation, and my very deep concern with imposing abrupt policy changes.

I believe everything we do down here, both on your end of Pennsylvania Avenue and ours, depends on a strong economy. And I have shared with you a copy of the letter that I have written to others, and will be meeting about the concerns raised in that letter later in the week. But I wanted to put on the record the intensity of my concern about abrupt policy changes about what I think to be probably regionally uneven regulatory action, and my really deep concern about the assumptions from which the comptroller's people are moving in the Northeast in terms of reviewing the strength of our banking industry. Thank you.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Pease.

Mr. PEASE. Thank you, Mr. Chairman. I have one more question for the Secretary.

In your testimony, you talk about the Exon-Florio provision in the 1988 Trade Act and the fact that only for national security do we make an exception to the nondiscrimination rules for foreign investment. You also make reference to a committee that you chair which reviews investment proposals from the viewpoint of the Exon-Florio amendment.

Could you give me some idea of how many investment proposals your committee has reviewed pursuant to this provision?

Secretary BRADY. I think in the last year, it is probably five or six. But Charles Dallara, why don't you answer the question?

Mr. DALLARA. Well the actual number of formal investigations we have had to initiate, Congressman Pease, is certainly in that area. I think it is seven now. But the actual number of cases that we have reviewed is well over 300 now. We have had to initiate form investigations only in the six or seven that the Secretary referred to. In only one case, has the President decided that it was appropriate to restrict or block the transaction due to reasons of national security.

Mr. PEASE. That was going to be my next question. So your committee has suggested to the President, and he has implemented a suspension or prohibition in one instance, is that correct?

Mr. DALLARA. That is correct, Congressman.

Mr. PEASE. Can you tell us what that example was?

Mr. DALLARA. Yes, sir; that one case was a Chinese Government-owned aerospace parts firm called Ratic. Some weeks ago, the President reached a decision that the debt transaction should not be allowed to go forward.

Mr. PEASE. I see.

Thank you very much.

Chairman ROSTENKOWSKI. If there are no further questions, Mr. Secretary, thank you very much for joining us this afternoon. We appreciate the time that you spent with us. It has been most informative.

Thank you.

Secretary BRADY. Thank you.

Chairman ROSTENKOWSKI. The committee stands adjourned.

[Whereupon, at 3:51 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

ASSOCIATION OF FOREIGN INVESTORS
IN
U.S. REAL ESTATE

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April 27, 1990

Mr. Robert Leonard
Chief Counsel
U.S. House Ways & Means Committee
Room 1102
Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Leonard:

The Association of Foreign Investors in U.S. Real Estate (AFIRE) appreciates the opportunity to submit for consideration by the U.S. House Ways and Means Committee comments concerning the Committee's recent hearings on the implications of Europe 1992 on American direct investment, and foreign investment in the United States.

AFIRE is a trade association of leading international financial and investment institutions actively engaged in investing in U.S. real estate. The Association collectively represents institutional investors from Australia, Canada, France, Japan, The Netherlands, United Kingdom, United States, and West Germany. Member organizations comprise virtually the entire spectrum of investment vehicles and activities in U.S. real estate; including pension funds, trust banks, and life insurance companies.

Our comments as submitted were developed largely from discussions among AFIRE's Executive Committee and Board of Directors. The comments address the value of foreign investment, the globalization of the worlds financial markets in general and real estate in particular, and the need for maintaining a fair and nondiscriminatory tax policy for foreign investors consistent with U.S. international tax treaty obligations and open market philosophy.

It should be noted at the outset that while AFIRE commends and supports the committee's goal of reviewing U.S. policy concerning foreign investment in the U.S., and the implications for U.S. economic and trade relationships with the Common Market and the U.S.S.R. and Eastern Europe, the Association urges the Committee to take into account the complex and interdependent nature of the international financial markets. The need for integrated tax and regulatory policies is vital. Unilateral legislative initiatives affecting international taxation and tax treaties affecting foreign investors will likely lead to reciprocal action by U.S. trading partners. United States policy toward foreign direct investment has long recognized that a free flow of capital benefits both host and investor countries. The U.S. generally provides foreign investors non-discriminatory treatment under U.S. law. In this regard, the elimination of obstacles to international investment is vital to the U.S. and world economy.

Value of Foreign Investment

Recent years have witnessed an increase in foreign investors involved in various transactions of U.S. assets. This has caused the American public and policy makers to voice concern over the financial sovereignty of the United States. Some people fear the increased debtor status of the U.S. and the growing foreign ownership of domestic companies and real estate. The argument has also been made that increased capital flows from abroad are the result of budget-induced interest rate increases. International investment brings about dollar appreciation, encouraging imports and thus increasing our existing trade deficits.

While data does show that foreign investment has increased substantially, it is not large compared to the scale of the U.S. economy. For example, total foreign holdings of U.S. assets amounted to about $1.7 trillion or 12% of all U.S. net wealth at the end of 1988, up from 5% in 1980. Also, the proportion of direct foreign investment in the U.S. is only about half that in a large European country.

Any consideration of policy change which could restrict or otherwise discourage the flow of foreign investment into the United States, subject foreign taxpayers to greater and unfair tax burdens, and violate existing tax treaties between the U.S. and foreign governments, must address the broad public policy and economic consequences of such action. Often overlooked in this debate is the value that foreign investment adds to the economy of the United States.

For instance, foreign investment creates lower interest rates. Because of the free flow of capital into the United States, interest rates remain lower than they would be if such investment were restricted and less capital was available. Lower interest rates encourage American citizens and businesses to invest domestically. Low interest rates makes home ownership more affordable for Americans and encourages more productive private investment.

Not only does foreign investment bring much needed capital into this country, but such investment enhances American productivity and improves management and technological know-how. This improves the United States international competitiveness.

Additionally, foreign owned enterprises and their subsidiaries employ 3,200,000 people and pay American employees in excess of $80 billion in wages annually.

Foreign investment clearly plays an important role in the U.S. and world economy by promoting economic growth. The natural process of economic integration and movement to market oriented economies mandates that the international exchange of goods, services, and securities remain open.

Globalization of Financial Markets and Open Investment Policy

The globalization of finance has been one of the most significant changes in business the past decade. As Alex Brown Realty Advisors reports in their 1990 Forecast, The global character of the financial markets is reflected in the rapid growth of transactions by U.S. and foreign investors in markets outside the investor's home country. A substantial increase in international portfolio and direct investments has occurred in capital markets around the world as European and Japanese investors have expanded their investment portfolios. As a result, larger amounts of capital are crossing national borders as investors throughout the world continue to increase their purchases of foreign securities and hard assets such as real estate.

In view of the uneven growth rates of the world's economies, and the growth of foreign stock markets relative to the U.S. markets, international diversification provides a means to pursue risk reduction that cannot be achieved by domestic investment alone.

Direct foreign investment in the U.S. is increasing faster than American's direct investment overseas. In 1988, for the first time, the book value of foreign holdings in the U.S. exceeded U.S. holdings in foreign markets. Figures for 1989 show foreign holdings totaled $390 billion, compared with U.S. holdings of $368.1 billion.

However, the true worth of U.S. holdings, which are older on the average than foreign holdings, is greatly underestimated since inflation leaves book values far below market values.

As the 1990's begin, it is obvious that the U.S. is a participant in the world economy. Consequently, many U.S. corporations, pension funds and life insurance companies are increasing their investment activities abroad. For example one large American financial institution has recently established a $2 billion global investment fund which will invest institutional funds in prime real estate properties throughout the world.

One reason why U.S. investors have traditionally not invested in real estate overseas is because the U.S. property market has been broad enough to fulfill their investment needs. European markets, in contrast are not as broad. However, as globalization advances, and as fewer prime properties are available in the U.S., American firms must now broaden their investment criteria to include global markets. The domestic pension fund market has over $2 trillion in total assets. It is estimated to grow to over $3 trillion by the end of the century. Typically, most funds allocate approximately 5% of their portfolio to real estate. Where and how these funds are invested will be determined by local, regional, national and global economic forces impacting on investment decision making.

The impact of globalization of the real estate industry, like other financial sectors, cannot be minimized. This has enormous implications for the economic health of the United States as well, for real estate is vital to the nations financial stability and well being. Real estate represents over 15% of the GNP and exceeds 11% of the national income. Additionally, over 6.5 million people are employed in all areas of the real estate industry.

AFIRE believes the free flow of international capital promotes economic opportunity. Discriminatory treatment is contrary to the free market principles which the U.S. promotes. With Eastern Europe moving inevitably toward free open market economies and the potential market that exists for American businesses, The U.S. should push for a greater reduction of trade and investment restrictions worldwide and at home.

In short, the U.S. must continue its strong commitment to an open, multilateral trading system, providing for non-discriminatory treatment under U.S. laws and regulations. This goal was stated in President Bush's Economic Report to Congress in February 1990:

> "To serve the interest of all Americans, we must open market here and abroad, not close them. I will strongly resist any attempts to hinder the free international flow of investment capital, which have benefitted workers and consumers here and abroad."

AFIRE urges the committee to insure that tax policy toward foreign investment in the United States is equitable and fair. Tax decisions affecting foreign investors also affect U.S. investors overseas. U.S. tax treaty policy must continue to promote bilateral trade and investment opportunities for the host and investor country.

Respectfully submitted,

Jeffry R. Dwyer
Corporate Secretary & General Counsel

SUBMISSION TO US GOVERNMENT AGENCIES CONSIDERING US-SOVIET ECONOMIC RELATIONS

BY
EDGAR M. BRONFMAN
PRESIDENT, WORLD JEWISH CONGRESS
CHAIRMAN, THE EAST-WEST FORUM
CHAIRMAN AND CEO, JOSEPH E. SEAGRAM & SONS, INC.
MEMBER OF THE BOARD, E.I.DU PONT DE NEMOURS & CO, INC.

JANUARY 25, 1990

In response to various official solicitations for comments on the economic relationship between the United States and the Soviet Union, I would like to recommend a fundamental shift in US policy. It is my considered opinion that an appropriate restructuring of the nature of the relationship requires a repeal of the Jackson-Vanik, Stevenson and Byrd amendments and the conclusion of several new agreements to foster greater US-USSR economic interaction.

Over the last six years, I have travelled frequently to the Soviet Union and Eastern Europe and have personally observed the changes taking place. While the political and economic reforms of President Mikhail Gorbachev remain fragile, I do believe they suggest a fundamental structural change in our policies should now be undertaken.

I wish to emphasize that I favor repeal of the Jackson-Vanik amendment and not temporary waivers or findings of inapplicability. The latter both impose continuing uncertainty on desired economic relations. I believe the original reason for the amendment is gone, and I see no reason for imposing such uncertainty and hampering business development.

In addition to repeal of the restrictive amendments, I also urge the United States government to move quickly on several pending items to stimulate US-Soviet trade. In meetings with Soviet leaders, they have stressed to me the importance they place on moving to greater economic interaction through the following mechanisms:

* An underlying US-USSR trade agreement
* A US-USSR tax treaty
* A US-USSR investment protection agreement
* A US review of its export restrictions as part of the Co-ordinating Committee on Multilateral Export Controls
* A US review of its application of slave labor policies with respect to Soviet products

- US assistance in gaining access for the Soviet Union as observers in General Agreement on Tariffs and Trade and other world economic and financial institutions.
- An enhanced role for economics in the context of the Conference on Security and Cooperation in Europe (CSCE).

I recognize that the Soviets could revert to earlier practices. The President, however, has sufficient authority outside of Jackson-Vanik to respond appropriately, and I am confident the Congress would not remain unresponsive in such circumstances. It is true that some refuseniks remain and promised codification of emigration and other human rights laws are still not enacted. Action on both must occur, but in the meantime it is important to proceed with the negotiation of new trade agreements aggressively and with dispatch.

Consider, please, the following arguments:

The Soviets have recognized their need and have expressed their desire to join the world economy and move their own economic system closer to that of free-market countries. I agree with President Bush's post-containment policy of helping the USSR achieve these goals.

An economically isolated and underdeveloped Soviet Union will lead to instability and a reduction in the standard of living of the Soviet people. The transition taking place is clearly traumatic. Diminishing that trauma in time and degree is fundamental to our own interests in the long-term.

Further, our own economy stands to gain by a stronger US-USSR economic relationship and greater participation by the Soviet Union in the world economy on a free-market basis. The faster the Soviet Union is able to provide access for its citizens to the world market of products, the earlier that process of mutually enforcing growth will occur.

And, the practice of linking US-Soviet trade to human rights issues, once the promised laws are enacted, will be no longer necessary. The goals of the Jackson-Vanik amendment have been in large part achieved. Jews, Pentacostals and members of other ethnic groups are free to leave the USSR. Over 71,000 Jews left in 1989 and it is expected that over 100,000 will leave this year. While not specified as part of Jackson-Vanik, but clearly part of our overall posture on human rights, it is important to note that official discrimination against Jews has ended, Jewish cultural centers have opened, Hebrew and religious subjects are taught freely, and Jews have begun to organize with the first meeting of the Soviet Jewish Congress held last December. In January, the elected co-chairmen of VAAD, the Soviet Jewish

Congress, officially attended a meeting of the World Jewish Congress Executive in New York City.

Let me further amplify from a businessman's point of view:

I believe our goal should be that trade and investment agreements provide the same benefits to American business that other European countries have negotiated for their business communities.

US export controls on technology transfers to the USSR need to be significantly reduced. While we should not lose sight of our security interests, overrestrictive export controls hinder US-Soviet economic development and provide Western European and Japanese business with a competitive advantage in the Soviet market. Just as Poland and Hungary need modern telecommunications systems to foster economic growth, such technology transfers to the USSR should only be restricted where a clearly discernible threat to US security exists.

Concrete steps should be taken to use the economic basket of the Conference on Security and Cooperation in Europe process to enhance East-West relations. The US delegation should vigorously pursue this goal at the March CSCE economic meeting in Bonn.

While negotiating a bilateral trade agreement with the USSR, the United States should concurrently negotiate an agreement on Soviet repayment of its lend-lease debt. A 1972 US-Soviet agreement on lend-lease (which should serve as a model for the new agreement) made Soviet lend-lease payments conditional upon the granting of unconditional Most Favored Nation (MFN) status to the USSR. A repeal of Jackson-Vanik paves the way for MFN and thus an agreement on lend-lease obligations.

President Bush spoke movingly after Malta about a new threshold that the United States, the Soviet Union and indeed the whole world can now cross. I believe this nation should endeavor to cross that threshold as unencumbered as possible by the archaic remnants of the old era. We should begin our economic relationship by recognizing that the Soviets have answered our complaints that led to the passage of the Jackson-Vanik amendment. To do otherwise is contemptuous of the significant steps the Soviets have taken and thus not worthy of the United States. It is time to move forward.

Statement by the Chubb Companies Submitted with Respect to the Hearings of the Committee on Ways and Means of the U.S. House of Representatives To Examine U.S. Trade Regulations with the Soviet Union and Eastern Europe, the Implications of "Europe 1992" on American Direct Investment, and Foreign Investment in the United States

I. INTRODUCTION

The Chubb Corporation and its domestic and foreign affiliates provide insurance coverage to their customers throughout the world. This statement is submitted by the Chubb Corporation to the Ways and Means Committee in connection with its study of U.S. trade relationships with Eastern Europe and the Soviet Union and the implications of "Europe 1992". The focus of the statement is on the effects that the Tax Reform Act of 1986 (the "1986 Act") changes to subpart F of the Internal Revenue Code of 1986 (the "Code") have had on insurance companies that are organized in foreign countries and are owned by U.S. shareholders. The 1986 Act changes have had deleterious, unforseen, and unwarranted consequences to the competitiveness of such insurance companies against their foreign-owned competition. The need to address these consequences is more critical than ever in view of the impending unification of Europe in 1992 and the dramatic opening of Eastern Europe to the Western economic community.

As discussed in detail below, the 1986 Act changes have caused the subpart F rules to adversely affect insurance companies that are not organized in tax havens, and that are not used by their U.S. shareholders to avoid tax. That consequence is caused by the failure of the high tax exemption to do what it was intended to do - to remove from subpart F those insurance companies operating in high tax jurisdictions.

Chubb recommends that, in light of the adverse effects to the competitiveness of U.S. owned companies caused by the unintended extension of the provisions of subpart F to insurance companies operating in high tax jurisdictions, the Code be amended to limit the 1986 Act changes to insurance companies organized and operated in recognized tax haven jurisdictions.

II. BACKGROUND

A. Insurance Income

From the inception of the Controlled Foreign Corporation rules in 1962[1] until the 1986 Act, the U.S. included in the definition of subpart F only certain limited insurance income of a controlled foreign corporation ("CFC"). Prior to the 1986 Act, the definition of insurance income for purposes of subpart F was limited to the income the CFC earned from insuring or reinsuring U.S. risks.[2] The subpart F income of a CFC is includable in the gross income of its U.S. shareholders pursuant to section 951 of the Code. Thus, U.S. persons could not escape current taxation on underwriting income by routing premiums on U.S. risks through a CFC in a tax haven.

The 1986 Act amended section 953 of the Code to redefine insurance income for purposes of subpart F. Insurance income subject to the current taxation rules of subpart F now includes any income attributable to the issuing (or reinsuring) of any insurance or annuity contract in connection with risks in a country other than the CFC's country of incorporation.[3] The intent of that change was to subject to U.S. tax the insurance income that was routed through a CFC incorporated in a convenient jurisdiction primarily for tax reasons. The staff of the Joint Committee on Taxation gave this explanation as to the reason for the change:

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[1] Revenue Act of 1962, P.L. 87-834, § 12.

[2] A CFC's income from insuring the risks of related persons was also subject to subpart F, as foreign base company services income.

> Insurance income generally represents the type of inherently movable income at which subpart F is aimed, since such income can frequently be routed through a corporation formed in any convenient jurisdiction. (Indeed, several countries have promoted themselves as jurisdictions for the formation of such corporations.) When a controlled foreign corporation insures risks outside of the country in which the corporation is organized, then it is appropriate to treat that income as if it has been routed through that jurisdiction primarily for tax reasons, regardless of whether the insured is a related or unrelated person. In all such cases, it is appropriate to impose current U.S. taxation under subpart F.

See Staff of Joint Committee on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986 ("Blue Book"), at 968.

Thus, unless the U.S. shareholder incurs the administrative burden and expense of establishing a separate subsidiary (or qualifying branch under section 964(d)) in each country, the shareholder will realize subpart F income whenever its CFC issues an insurance contract to an unrelated person covering risks other than in the CFC's country of incorporation.

B. Investment Income

An insurance company, in the ordinary course of its business, invests its premiums in order to generate the necessary assets to pay off future claims. Many foreign jurisdictions, as do many states in the U.S., impose capital and legal reserve requirements and solvency requirements on insurance companies. Thus, in order to write insurance and accept reinsurance premiums, CFC's must maintain and invest a certain portion of their assets in connection with their insurance business.

In recognition of the fact that insurance companies must invest their assets, Congress in 1962 provided an exception for insurance companies from the general rule that passive investment income of a CFC is subpart F income. Thus, prior to the changes made by the 1986 Act, Code section 954(c)(3) provided that dividends, interest and gains from the sale or exchange of stock or securities derived from the investments made by an insurance company of its unearned premiums, its reserves, and a percentage of its earned premiums (provided they were received from an unrelated person) were not subchapter F income.

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[3] In the Technical and Miscellaneous Revenue Act of 1988, section 964(d) was added to the Code to allow a qualified insurance branch of a CFC to be treated as a separate foreign corporation created under the laws of the foreign country in which it operates, provided separate books and accounts are maintained for the branch, its principal place of business is in such foreign country, it would be taxable under subchapter L if it were a domestic corporation, and it files the appropriate election.

The 1986 Act repealed the above exception, and thus characterized as subpart F income all passive income earned by a CFC in the insurance business. The intent of that change was to prevent excessive opportunities for taxpayers to route income through foreign countries to maximize U.S. tax benefits. According to the Blue Book, "[t]he proliferation of U.S. - controlled banking and insurance companies in various tax haven jurisdictions suggested that many taxpayers were in fact taking advantage of the ability to earn dividends, interest, and gains through such entities, on which the U.S. tax was deferred and the foreign tax was often insignificant." (Emphasis added.) *See* Blue Book at 966.

C. High Tax Exception

The high tax exception provided in section 954(b)(4) was intended to prevent inclusion in subpart F of insurance income, as well as passive income of an insurance company, that was not generated with a U.S. tax avoidance motive. Blue Book, at 983.[4] The high tax exception takes out of subpart F any item of income (other than foreign base company oil-related income) received by a CFC, if the taxpayer establishes such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax under section 11 of the Code.

III. CONSEQUENCES OF THE 1986 ACT CHANGES

Due to the complexity of the interaction of the subpart F provisions with the U.S. tax provisions that apply generally to insurance companies, several of the consequences of the 1986 Act changes are now just coming to light. An examination of the legislative history of the 1986 Act shows that these consequences were not intended, or even contemplated, when the changes to subpart F were made.

As a result of the 1986 Act changes, CFC's in the insurance business are generating subpart F income taxable to their U.S. shareholders, notwithstanding the fact that the CFC's are not located in tax havens and notwithstanding the fact that the CFC's have not manipulated their income for tax avoidance purposes. That unintended result is a consequence of the 1986 Act modification to the classes of insurance income subject to subpart F current taxation and the failure of the high tax exception of section 954(b)(4) to fulfill its purpose - to remove from subpart F a CFC's income that will be subject to foreign tax at a rate equivalent to the U.S. corporate rate.

The failure of the high tax exception to operate in the manner intended is due to the fact that most foreign countries tax insurance income differently than the U.S. In fact, some of the incongruities between the U.S. tax treatment and the foreign tax treatment results from changes to the insurance provisions of subpart L of the Code enacted by the 1986 Act.

For instance, foreign countries, including high tax jurisdictions, typically do not require that an insurance company discount its reserves when computing taxable income (Code § 846), or include in income a percentage of its unearned premiums (Code § 832(b)(4)). CFC's also can generally carry forward their pre-1987 losses to offset current taxable income in their countries of organization while subpart F rules prohibit the carry forward of pre-1987 deficits. These and other timing and accounting differences between the taxing systems of the U.S. and foreign jurisdictions can, and often do, cause a CFC to have a broader tax base for subpart F purposes than it has for purposes of its country of organization. Thus, even though the rate of tax in a foreign jurisdiction is similar to the top rate in the U.S., because of the narrower tax base for foreign purposes, many CFC's fail the test of section 954(b)(4) and do not qualify for the high tax exception to subpart F income.

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[4] The Blue Book states: "...since the scope of transactions subject to subpart F is broadened under the Act and may sweep in a greater number of non-tax motivated transactions, Congress expected that the flexibility provided by a readily applicable exception [section 954(b)(4)] for such transactions would become a substantially more important element of the subpart F system."

IV. A CHANGE IS NEEDED

Because of the problems discussed above, a change is needed. An American owned business operating abroad whose shareholders are subject to a greater tax burden because of the subpart F rules is at a disadvantage when competing with companies located in the same area who can operate at a lower overall tax cost. The nature of the ever increasing global economy is such that CFC's are being asked more and more to insure the cross border risks of their clients. Thus, for instance, a German company may acquire a factory or other property in another country that it wants to insure with its normal insurance carrier. A CFC organized in Germany should be able to sell such cross border insurance to an unrelated party without being put at a competitive disadvantage. It would be administratively burdensome to require the German CFC, as the cost of accepting such business, to establish a separate corporation in the other country or maintain a separate branch that would qualify under section 964(d) of the Code. Moreover, such a step as this would not address the problem of current law subpart F treatment of investment income on reserves required by local laws in countries in which the insurer is doing business, a problem not encountered by non-U.S. companies competing against U.S. owned insurance companies.

The pace of such cross border activities is surely to increase with the economic integration of Europe scheduled for 1992 and the opening up of Eastern Europe now taking place. U.S. owned companies should be able to participate in that business without being hampered by unintended tax burdens under subpart F.

V. PROPOSALS

In order to correct the unintended results of the changes made by the 1986 Act to subpart F, and limit subpart F to tax haven CFC's, the following proposals are made:

1. allow insurance company CFC's to use their country of incorporation tax accounting rules to determine eligibility for the high tax exception under section 954(b)(4) of the Code;

2. exclude from subpart F the investment income attributable to the retention of assets by an insurance company CFC mandated by local law, to the extent not present in a tax haven country. For that purpose, a tax haven would be any country with a corporate income tax rate less than 50 percent of the rate imposed by section 11 of the Code;

3. treat as one country for purposes of section 953 of the Code all countries, other than tax haven countries (as defined above), or alternatively, treat the European Common Market countries as one country for purposes of section 953 of the Code.

Submitted By:

Robert A. Marzocchi
Vice President
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OPPENHEIMER WOLFF & DONNELLY

STATEMENT OF CHARLES M. BRUCE, ESQ.
OPPENHEIMER WOLFF & DONNELLY
ON
TAXATION OF FOREIGN INVESTMENT IN THE UNITED STATES
BEFORE
THE HOUSE COMMITTEE ON WAYS & MEANS

Oppenheimer Wolff & Donnelly represents a number of non-U.S. high net worth individuals and families who have a variety of direct investments in the United States. Drawing from our experience in representing several of these individuals and families, we would like to submit the following comments on the subject of U.S. federal taxation of non-U.S. investors.

The views expressed herein are solely those of the author, and are not offered on behalf of any client. Moreover, it should not be inferred that these comments represent the expression of views of any other person or group.

1. The U.S. should not amend its rules relating to the taxation of non-resident aliens and foreign corporations on U.S.-source capital gains. Proposals for taxing such individuals and corporations on such gains where the recipient is a 10% or greater shareholder of a U.S. corporation should be rejected.

The normal international tax rule is for the source country, in effect, to cede tax jurisdiction to the residence country. If the U.S. were to impose a tax and other attractive source countries did not follow suit, the amount of capital being invested to the U.S. would be reduced -- to the United States' detriment.

It should not be assumed that other countries will follow suit in imposing taxes on the appreciated value of capital assets. Other countries did not follow in the footsteps of the U.S. when, for example, the U.S. began taxing its citizens' and residents' so-called "tax haven income" (by enacting Subpart F of the Internal Revenue Code), but instead they either did nothing or drew up short. Since the early 1960's, the scales of capital exportation and importation have shifted; and, therefore, it is even less likely today that other countries will enact anti-capital importation rules simply because the U.S. "leads the way."

It has been said that imposing a capital gains tax on significant direct investment is less likely to cause a reaction than imposing such a tax on portfolio stock and commodities investment. In fact, we are impressed with the volatility of so-called "bricks and mortar" investment; that is, investors, in reaction to a radical change in the after-tax returns on investment, can and will shift investment patterns and, for example, locate manufacturing plants outside the U.S.

There certainly should be no change in tax policy without taking into account the long-term trend towards reduction in trade and tariff barriers.

In our experience, the principal attraction of the U.S. for individuals and families is its openness and the mobility of U.S. society. It should not be overlooked, however, that these persons can enter the U.S. and establish or acquire businesses (and the income produced in the U.S. will be taxed here), or they can enter the U.S., leaving their businesses' plants and offices outside the U.S. (and, with the use of non-U.S., non-grantor trusts and perhaps other vehicles, the income produced outside the U.S. properly will not be taxed here).

If any changes are to be made in this area, they should be prospective only. Existing interests should be "grandfathered" or at least made the subject of favorable "fresh-start basis" rules.

2. Congress should be slow to enact tax proposals that required extraterritorial enforcement mechanisms. Whenever a national authority legislates beyond its means to effectively enforce the law, it invites an erosion in voluntary compliance.

The imposition of the Foreign Investment in Real Property Tax Act ("FIRPTA") tax required the promulgation of an extremely expansive set of regulations which necessarily draws up short of taxing the sale of stock in a foreign corporation by one foreign person to another, when, for example, the foreign corporation owns 100 percent of the stock of a U.S. corporation which, in turn, owns a U.S. real estate parcel. It was recognized that the U.S. has no way of policing this type of transaction and that to try to enforce such a tax would jeopardize international markets.

As a result, the U.S. is close to inadvertently creating a secondary market in such foreign corporations, for foreign buyers and sellers, in certain types of properties -- for example, raw land in resort areas or "high-end" residential properties.[1]

The same problem might arise if the U.S. were to impose a tax on significant foreign direct investments, especially as the "marketplace" for foreign owners of U.S. businesses becomes thicker.

3. Congress should be mindful that provisions requiring a full measure of disclosure of ultimate beneficial ownership (with the penalty being punitive taxation) operate as a form of trade barrier for many high net worth individuals and families.

It is not the case that these persons are necessarily bad people or law-breakers by U.S. standards. Often they are genuinely, and quite rationally, concerned about their exposure to political and other risks in their home jurisdiction. Not all flight capital is tainted. While the U.S. someday may wish, in effect, to reject all flight capital -- from its real estate, direct investment, and securities/commodities markets, this step should not be taken without careful consideration. The openness of competing markets may or may not be deemed to be a factor.

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[1] Foreign buyers of these companies are generally not concerned with the inability to step-up the basis of the underlying real estate.

4. U.S. taxpayers and foreign investors alike can only benefit from a more modern, more flexible bilateral income tax treaty system. To foster such a system, it is no longer desirable for such treaties to be the sole province of the Treasury Department with review by the Senate Foreign Relations Committee and ratification (or non-ratification or ratification with reservation(s)) by the Senate.

The present situation leads to enactment of provisions overriding treaties and to an occasional "public hanging" of a treaty provision to which some faction in Congress strongly objects (for example, the anti-captive insurance provisions introduced in the Conference Committee in 1986).

It would be better for all concerned if some version of the following procedures relating to treaties were put in place.

- Congressional jurisdiction over tax treaties should remain solely with the Senate Foreign Relations Committee. This is necessary because tax treaties involve a number of sensitive questions relating to international relations.

- Consultation between Treasury Department and Congress with respect to treaties should be required. The Speaker of the House, on the recommendation of the Chairman of the Ways and Means Committee, should appoint a Majority and Minority Member of that Committee and the President of the Senate should appoint, on the recommendation of the Chairmen of the Foreign Relations and the Finance Committees, a Majority and a Minority Member of both of those Committees to act as Congressional representatives in tax treaty negotiations. These representatives should be invited to sit in on treaty negotiations or informal meetings in conjunction therewith; and, in any event, they should act as points of contact to be briefed on significant treaty developments.

- Joint resolutions should be passed approving model income and estate tax treaties. Hearings should be held in the House and the Senate on the Treasury Department's model income and estate and gift tax treaties. A joint resolution then should be sent to the House Ways and Means Committee on the House side and the Foreign Relations Committee and the Finance Committee on the Senate side and subsequently considered by both the House and the Senate.

- Tax agreements embodying deviant provisions should be sent to both the House Ways and Means Committee and the Senate Finance Committee for consideration and approval. When treaties that deviate substantially from the Congressionally-approved model treaties are submitted to the Senate, the deviating provisions should be put in tax agreements. Such tax agreements should be introduced by the Chairman of the Ways and Means Committee, on request of the administration, and sent to the tax-writing committees. There need be no legislative requirement that the Administration propose tax agreements, only and understanding that such agreements will facilitate the treaty process. The agreements could be placed on a "fast track." The treaties themselves, which would still be sent only to the Senate Foreign Relations Committee, should be treated as not ready to be placed on the calendar until consideration of any accompanying tax agreement is completed.

We submit that these or similar procedural changes would be constitutional. See Joint Committee on Taxation, Tax Reform Proposals: Taxation of Foreign Income and Foreign Taxpayers (Joint Committee Print JCS-25-85), dated July 18, 1985, pp. 141-147.

The Senate Finance Committee considered a version of these proposals in 1978. See Hearing Before the Subcommittee on Oversight of the Committee on Ways and Means, House of Representatives, 96th Cong., 2d Sess. (April 29, 1980), pp. 159-161 (testimony of Charles M. Bruce). Twelve years later, this type of proposal is even more relevant and, we suggest, acceptable to the various constituencies.

Testimony of T. Boone Pickens, Jr.
Submitted to the
U. S. House of Representatives
Committee on Ways and Means

Mr. Chairman and members of the Committee, my name is Boone Pickens. I appreciate the opportunity to present my views. I am General Partner of Mesa Limited Partnership based in Dallas, Texas. I am chairman of a private investment firm called Boone Co. which also is based in Dallas. I commend you for holding these timely hearings to consider U.S. foreign investment policy and U.S. trade relations with the Soviet Union and Eastern Europe.

Boone Co's Koito Experience

My interest in the foreign investment policy of the U.S. is due, in part, to the fact that Boone Co. now owns approximately 26% of the stock and is the largest shareholder of Koito Manufacturing Company Ltd., a Japanese automotive lighting company. Boone Co.'s position is truly unique because, as foreigners, we have acquired such a large position in a Japanese company. The reaction from the Japanese business and financial community has been particularly intense. Since acquiring the stock last year, the treatment we have received by corporate Japan contrasts sharply with the treatment accorded Japanese investors in the United States, and it is symbolic of the current trade relations between our country and Japan.

The Japanese quest for world economic dominance is evident in the treatment that Boone Co. has received from the Board of Directors of Koito. At issue is what I call silent trade barriers that prevent Americans from entering Japan's markets, while the Japanese are free to invest in the United States at will.

Despite our position as Koito's largest shareholder, our requests to the Koito Board for even the most rudimentary financial and operating information about the company, which would be granted as a matter of course for shareholders in this country, have been received with curt and evasive replies. These responses were inappropriate for any stockholder, let alone the largest one. As a last resort, we have filed a lawsuit in Japan to compel the production of this information. We simply saw no other way to obtain the data that is critically necessary to undertake a prudent investment analysis of the company's future.

While Boone Co. -- Koito's largest shareholder -- cannot obtain representation on the company's board of directors, Toyota Motor Co. -- the next largest shareholder -- controls at least three seats on the board and appoints key operating management. This treatment is in direct contrast to the ability of Japanese investors to enter the corporate board rooms of America. We have learned that numerous manufacturing companies in the U.S. have Japanese board members. In Japan, however, board members are often required to be Japanese. For example, in 1968, Eiji Toyoda, then president of Toyota Motor, announced at the general meeting of shareholders that "directors and auditors of the company should be Japanese." The announcement was challenged in court, but Toyota insisted that this stipulation was necessary so that the company could defend itself from being dominated by foreign capital. In 1975, Toyota formally deleted this portion from its corporate articles, although it is still a practiced policy under Eiji Toyoda who now serves as chairman of the board.

From what I've observed, our experiences at Koito are characteristic of the entire corporate system in Japan, which is geared toward the denial of a meaningful flow of information to shareholders.

Absence of Reciprocity in Investment Opportunities

Mr. Chairman, I am not an expert in foreign affairs or trade relations. However, I do travel quite extensively, and I speak to many different groups of people. During my travels, I have sensed that my frustrations in dealing with corporate Japan are not unique. Many Americans are frustrated and extremely concerned about our own economic future in light of the significant advances by the Japanese in recent years.

These observations are consistent with the results of a poll conducted by Louis Harris and Associates for Business Week during the week of July 7-11, 1989. This poll of 1,250 adults nationwide asked a number of questions about the U.S. trade deficit with Japan and economic relations between the two countries.

The question was asked, "If you had to say, which do you now think is a more serious threat to the future of this country -- the military threat from the Soviet Union, or the economic threat from Japan?"

The answer provided an incredible statistic.

Military threat from the Soviet Union	22 percent
Economic threat from Japan	68 percent
No difference	5 percent
Not sure	5 percent

By a margin of three to one, the American people think the economic threat from Japan poses a greater risk to the United States than the Soviet military. Bear in mind that this poll was taken before the fall of the Berlin Wall.

Japan has the second largest economy in the world next to the United States, and yet it continues to maintain a closed system. The Japanese roam the entire world, trying to invest with their vast capital, but there is only one place -- the United States -- where they have a truly open invitation. Ironically, they are unwilling to provide access to foreigners seeking similar opportunities within their markets.

In spite of the fact that Japanese corporate law is largely patterned after its U.S. counterpart, significant differences between U.S. and Japanese corporate law, are evident. The Japanese corporate structure and law provide little opportunity for independent shareholders to exercise any meaningful rights. The benefits of corporate ownership and control are vested firmly with the members of the keiretsu system of interlocking corporate families. The Japanese corporate culture routinely places the interest of the employees above those of the shareholders, in part, because Japanese corporations have no outside directors to voice shareholder concerns.

Statutory rights that exist in theory under the Japanese Commercial Code have little practical effect because Japanese board members have great latitude in dealing with shareholder requests. Litigation is often not a viable means of enforcing shareholders' rights, because lawsuits are generally frowned upon in Japan and involve significant up-front fees for plaintiffs, particularly foreign plaintiffs. In sum, the practical applications of the Japanese law do not reflect the spirit of greater shareholder participation underlying the revised Commercial Code. Boone Co.'s dealings as a shareholder with the Board of Koito support these conclusions.

On the other hand, there is no doubt that the United States economy is the most open in the world. Investors, foreign or domestic, need only to comply with our federal and state securities laws in order to freely participate in our equity markets. Our laws are uniformly applied in principle, custom and usage. Foreign investors are not at a competitive disadvantage.

This holds particularly true for the Japanese, who face few real barriers to entry into the United States capital markets. Sony Corp. purchased CBS Records in 1987 for $2 billion; Bridgestone Corp. of Japan bought Firestone Tire and Rubber Company for $2.65 billion in 1988, and in 1989 Sony Corp. bought Columbia Pictures Entertainment Inc. for about $3.4 billion.

Japanese companies are not only purchasing control of our corporations, but they are also buying significant amounts of real estate property throughout the United States. Last year, Mitsubishi Estate Co. agreed to pay $846 million for a 51 percent interest in the Rockefeller Group Inc., which owns Rockefeller Center and other buildings in mid-town Manhattan. The most prestigious business address in America is now controlled by the Japanese.

This is only the latest of many billions of Japanese purchases of American real estate, from Hawaii, to Los Angeles to New York. Nippon Life Insurance and Dai-ichi Mutual Life Insurance, both shareholders of Koito where we now own 26 percent, are two of the Japanese financial conglomerates using huge cash surpluses to increase holdings of American real estate.

These Japanese companies aren't limited to a minority stake in U.S. corporations; many purchase 100 percent of the outstanding shares of the company and gain complete control. Americans have no such opportunity in Japan. Because of interlocking ownership, an American purchase of complete control of a Japanese concern would be virtually impossible.

Japan's closed Economy Benefits a Select Few

Thus, as the United States maintains an open economy, Japan vigorously maintains a closed system. The cartel members who run Japan's economy will take whatever action necessary to ensure the maintenance of the *status quo* and their own economic interests. A select few members of the business and financial community exercise dominant control over the policy of Japan's major, public companies. This small group can cause one company to execute a contract on less than favorable terms in order to benefit the parent company. Such a cozy system enables incumbent managers to reward one another with favorable contracts between companies, without regard to the impact on dividends or the shareholders. The cartel-like management uses these relatively low-cost contracts to undercut competition in the world market and thereby achieve its ultimate goals -- increased world market share. We have all read recent examples of bid rigging by Japan's major construction companies.

The Japanese themselves are aware of this system. A recent article in a leading Japanese business journal, the *Nikkei Sangyo Shimbum*, confirms my view. An unnamed Japanese auto parts manufacturing executive is quoted as saying "unlimited demands from trading partners who are major shareholders are a headache to us." The article further states,

> "Their power as major shareholders is far greater than that of trading corporations. If not properly handled, eventually the heads of corporations would be replaced. In the short term, the merit of mutual interlocking shareholding is that the shareholder company can acquire shorter delivery time, stable supply of quality products at lower prices by maintaining long-term, stable trading relations. Shareholder companies have the right to intervene in the operations of the companies in which they have stakes in such means as technical guidance to improve productivity. Even though the dividends are small, the system fully pays off, or brings even greater benefit." (October 5, 1989)

This "greater benefit" to Japan is nothing more than the absence of competition. For example, Toyota never has any problem obtaining delivery of its auto parts lighting system, because it vigorously exercises control over the business affairs of Koito. The present chairman of Koito worked for Toyota for more than 30 years prior to taking the Koito position. Other top officials at Koito have also been employed by Toyota. There is very little question that the incumbent managers of Koito owe their loyalty to Toyota to the exclusion of other shareholders.

The Domestic Economy of the U.S. is At Risk

Mr. Chairman, the problem is not limited to the closed system maintained by Japan. In dealing with the Japanese, you must be concerned with more than the inability of Americans to penetrate the barriers in the Japanese economy. Exhibit A shows that in 1987, Japanese direct investment in the U.S. was more than twice the level of U.S. direct investment in Japan. However, the more frightening prospect of investment policy is that the trend will get worse every year. As Exhibit B reflects during the past several years, Japanese investment in the U.S. has *increased five fold*, while U.S. investment in Japan has been *cut in half*.

I urge you to examine the extent to which the Japanese are exporting goods and services. The Japanese have exported to the United States roughly $88 billion of goods and services from July 1, 1988 to June 30, 1989. Of that total amount, three major shareholders of Koito account for 18 percent or $16 billion. The chart attached as Exhibit C illustrates that this is how the cartel works.

The automotive and electronics industry provides a good example of my point. Toyota, Nissan and Matsushita -- which together own 30.2 percent of Koito -- are among those companies that contribute significantly to the huge trade deficit that this country faces with Japan. Initially, the Japanese entered this market merely by achieving significant levels of retail sales of automobiles and electronic products.

In recent years, the Japanese have aggressively entered the manufacturing business in the United States by opening their own production facilities. Before we know it, the Japanese will have imported their system of cartel-manufacturing to the United States. They are keeping American competition out of Japan, and at the same time are exporting their system of cartels into the United States in contrivance of our anti-trust laws. This system is described in an article from the Nihon Keizai Shimbun (the Japan Economic Journal) which appears as Exhibit D.

If Toyota's financial position is enhanced through its all-powerful relationships with the Koito's of Japan, what is Toyota, Honda or Nissan doing with its same Japanese-owned suppliers who have followed their plants to the United States?

For the past 100 years, our economy has been without trusts or cartels. We cannot permit the Japanese to sneak theirs through the backdoor. Busting Japan's trusts is not only essential to free trade, but with more and more Japanese investment in the United States, it is critical to the preservation of our own free enterprise system of open competition.

We must also be concerned about the increasing ability of the Japanese to exert their dominance on the world market. The radical changes in Eastern Europe and the emergence of EC 1992 present significant new markets for the Japanese. Already, they have created ways to maximize their presence in Europe. Recently, I have seen several articles in European papers, which document the potential ability of the Japanese to undermine the EC's import restraints through the use of North American and European based production facilities. Our trade policy certainly should not permit Japanese automobiles --or any other goods for that matter -- manufactured in the U.S. to be counted as "American" for the purposes of U.S.-EC trade relations.

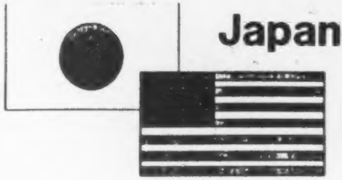
The last few months have been particularly interesting for me as I have always been challenged by unique investment opportunities. I have never minded the competition, and I have come to realize that the Japanese use two rule books, one of which says they win and the other which says we lose. If we continue playing on Japan's unlevel playing field, I am convinced that the United States will not remain an economic leader in the emerging global economy of the 1990s.

In closing, I want to thank you, Mr. Chairman, as well as members of the committee and your respective staffs. I appreciate the difficulty of the task that you have undertaken. It has taken us several years to realize the magnitude of our trade problems and the enormity of the stakes involved. Your efforts are a critical first step in mapping out a strategy for opening the world economy to each potential entrant.

Passage of Legislation Would Send the Right Message

Finally, I urge your support of H.R. 3699, the bill introduced last by Rep. Tom Campbell (R-CA), which continues to attract additional cosponsors. Also, Rep. Don Sundquist (R-TN) has introduce H. Con. Res. 216, which urges the reduction of barriers to Americans trading with or investing in Japan. Moreover. I understand that other Members of Congress are actively considering the introduction of additional proposals to solve the trade problems that this Committee faces. We have heard enough talk; we now need action. All of these legislative remedies will help to produce some real results instead of continuing the exchange of pleasantries. Therefore, I would hope that the Committee would act favorably on this type of legislation. Thank you for the opportunity to express my views.

EXHIBIT A



Japanese Investment in the U.S.
vs.
U.S. Investment in Japan

1987 Estimates

(Source: U.S. Bureau of Economic Analysis)

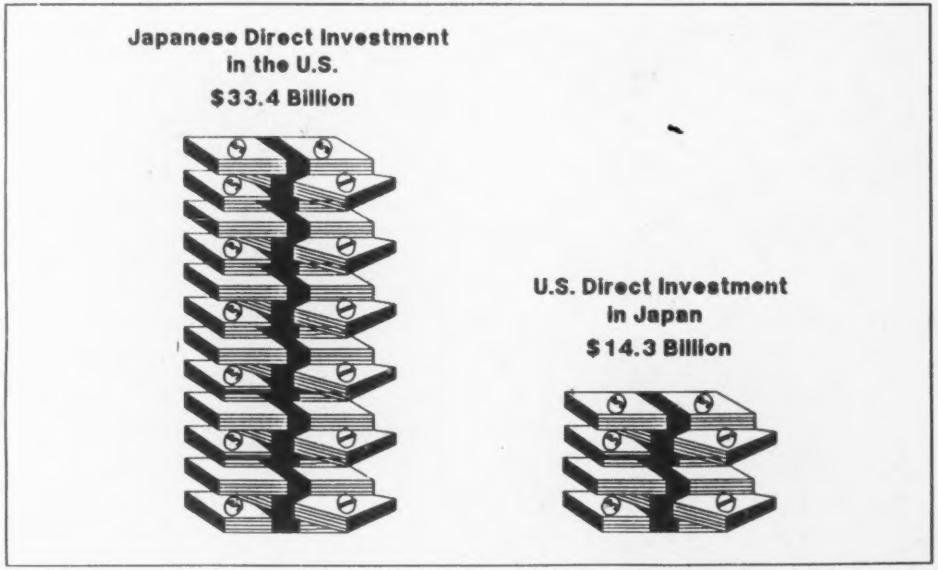


EXHIBIT B

ROLE OF FOREIGN DIRECT INVESTMENT IN THE UNITED STATES AND JAPAN

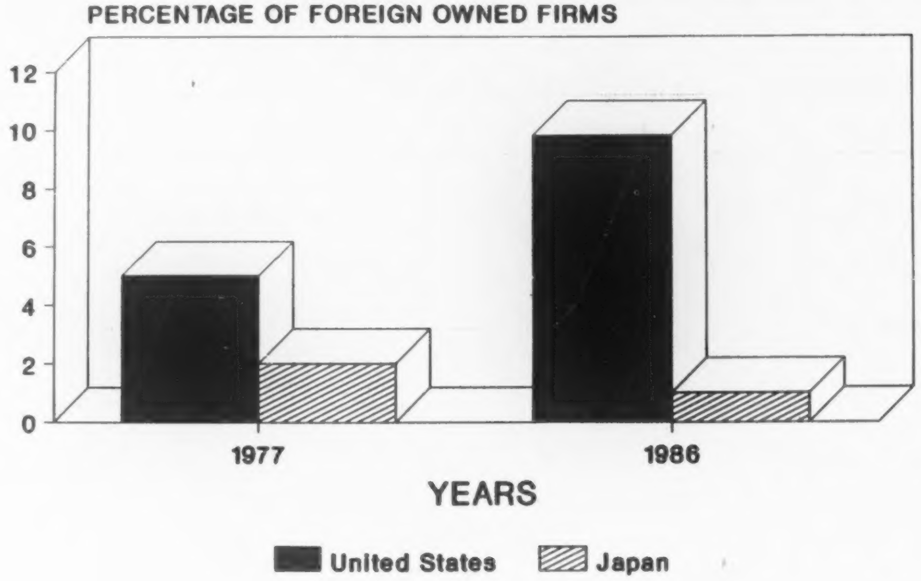


EXHIBIT C

KOITO MANUFACTURING COMPANY LTD. SHAREHOLDERS THAT EXPORT TO NORTH AMERICA

	Toyota Motor	Nissan Motor	Matsushita Electric Industrial
Profit before tax	569,888	177,974	249,493
Gross sales	7,190,590	3,580,110	4,074,674
Total assets	6,316,191	3,117,499	2,928,861
Exports amount	2,462,581	1,462,839 (only cars)	1,378,436
Ratio of the export to North America to the total export	55.0%	47.0%	36.2%
Amounts of export to North America	1,354,419	687,797	498,993
Share among the total Japanese export to North America	9.7%	4.7%	3.7%

Notes:

1. All figures represent million yen

2. Figures for Nissan and Matsushita are based on the period beginning April 1, 1988 and ending March 31, 1989. The figures for Toyota are based on the period beginning July 1, 1988 and ending June 30, 1989.

3. Total amount of the Japanese export is for the period beginning April 1, 1988 and ending March 31, 1989. During that time total exports to North America were valued at 13,482,621 million yen, and the total to U.S. were valued at 11,846,329 million yen. For the period July 1, 1988 through June 30, 1989, total exports to North America were valued at 13,964,314 million yen and the total to the U.S. were valued at 12,280,873 million yen.

4. The following sources were used to compile this chart:

   a. The Annual Securities Reports 1989 for Nissan, Matsushita, and Toyota.

   b. The Summary Report on Trade of Japan 1989 (prepared and distributed by Ministry of Finance.)

EXHIBIT D

(full translation)

Nihon Keizai Shimbun
(Japan Economic Journal)
October 20, 1989
Circulation: 2,713,000

-- Structural Adjustment --

Part I Power of Groups -- 7

Presidents of four automobile parts makers -- Nissan Shatai Co., Ltd., Calsonic Corp., Aichi Machine Industry Co., Ltd. and Tokyo Sokuhan Co., Ltd. -- were all changed at the end of this June. All the four companies are members of the "Takara-kai," made up of Nissan Motor-affiliated parts companies. All the four new presidents have been sent from Nissan according to the established custom.

An ex-Nissan official who stepped down from presidency at the end of this June says, "All we can do is to just recommend our choice. Everything is decided by Mr. Yutaka Kume, president of Nissan. I hear that a person who was not the initial choice was appointed president of Kanto Seiki Co., Ltd. this May, since the top personnel change was got wind of in advance. Therefore, we had no idea who would be sent to the four parts makers."

Executive managing directors, managing directors or directors of Nissan have been customarily named presidents of major Takara-kai member corporations in accordance with the scale of these corporations. Their tenure is four years in two terms. At the end of their tenure, they will retire without becoming chairman of the company. This is an unwritten rule of the Takara-kai. The top personnel affairs of these Takara-kai member corporations are completely under ths control of Nissan.

Such Nissan-affiliated parts makers' groups as the "Takara-kai" and the "Shoho-kai" are like lifelines for Nissan. A car is assembled using more than 30,000 parts. Cars cannot be completed if any one of the conditions, including quality and the appointed date of delivery of parts, is not satisfied. Therefore, the strength of parts affiliate is directly reflected in the competitiveness of Nissan. Against this background, it is important to maintain strong parts affiliates. To this end, along with the possession of shares of the affiliated parts makers, sending Nissan executives to these companies is one of the most important means.

According to the estimation of the industry, Japanese automobile makers such as Toyota and Nissan manufacture approximately 30 percent of their parts for themselves, while General Motors Corp. and Ford Motor Co. manufacture more than 50 percent for themselves. The gap, more than 20 percent, is produced by Japanese affiliated parts makers.

In some cases, Japanese complete car assemblers have made their affiliated parts makers their wholly-owned subsidiaries, like one division within GM or Ford, by processing the majority of the shares of these parts makers.

In many cases, however, complete car makers hold about 30 percent of the shares of their affiliated parts makers at the most.

Yet, complete car makers send their officials as presidents or directors of their affiliated parts makers, and incorporate these makers into their parts makers' groups which are practically under their control. They even unify labor unions. The result is the affiliate groups special to Japan, which include not only capital relations but also other management matters.

Complete car makers have pressed their affiliated parts makers for discounts in return for stable and quantitative orders they give. Parts makers have met such requests from complete car makers even at the cost of profit and dividends. In other words, complete car makers, which are shareholders of these parts makers as well, have tolerated "low" directors, discounts and stable security of parts -- "invisible dividends."

This is an established "business rule" adopted not only by the automobile industry but also by the overall industrial circles in Japan.

This has made great contributions to the enhancement of international competitiveness of Japanese corporations.

However, this affiliate system of Japan appears to be a system ignoring the interests of shareholders to overseas shareholders who cannot enjoy such "invisible dividends." It seems to overseas parts makers, who are not the members of the Takara-kai, to be a very exclusive trading form.

Boone Co., the chief shareholder of Koito manufacturing Co., Ltd., requested Koito at the end of September to increase the interim dividend for the period ending in September, 1989 from -Y4 per share to -Y7 per share.

Kanji Ishizumi, a lawyer representing Boone Co., says, "Considering the Koito's dividends, which are lower than those of American automobile parts makers, it is clear that Koito is giving Toyota such invisible dividends as 'discounts' and 'observance of appointed dates of delivery.' It is unfair to the shareholders who, unlike Toyota, cannot get profit other than dividends."

If Koito were a totally owned subsidiary of Toyota or an unlisted corporation, it would be allowed to have any affiliate relations. However, it should give the top priority to the interests of shareholders as long as it is enjoying merits of stock listing, including the fund-raising at low interest rates through the market," he adds.

A parts maker president says, "If it had not been Mr. Pickens that cornered Koito shares, serious discussions would have been developed about the affiliate relations in the Japanese automobile industry . . . . " He is disappointed that the focus of the Koito issue has shifted to whether or not Mr. Pickens is a greenmailer. The real aim of Mr. Pickens has not been made clear yet. However, claims of Mr. Pickens are skirting along the heart of the Japanese affiliate system as a whole.

A Nissan director says in a puzzled way, "We used to be asked about our relationship with our affiliated parts makers by GM and Ford. Before the Koito issue surfaced, I had told them that our affiliated parts makers were something like their parts business divisions and that such parts makers were part of Nissan. However, now I cannot make such a reply. I wonder how I can explain our relationship with our affiliated part makers."

A Toyota director says, "It may be the time we should review the establishment of a legal system that will streamline the relationship between parent companies and their subsidiaries, allowing a holding company system. Then, issues like the Koito case would not get bogged down this far."

Toyota has realized through the recent incident that the affiliated relations, which are extremely vague in the light of the logic of capital centered on the corporation system, are about to be at a turning point. A major automobile maker top executive notes, "Japanese manufacturing industries which greatly depend on affiliated makers would be severely damaged if legal defensive means against hostile mergers and acquisitions (M&A) were not firmly established." The idea to revive the holding company system has been rapidly spreading among Japanese corporate managers.

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PSA

THE HOUSE COMMITTEE ON WAYS AND MEANS
HEARING ON FOREIGN INVESTMENT IN THE UNITED STATES

STATEMENT OF THE PUBLIC SECURITIES ASSOCIATION

The Public Securities Association (PSA) is pleased to submit this statement to the Committee on Ways and Means on the issue of foreign investment in the United States. PSA is the international trade association of banks and brokerage firms that deal in U.S. Government and Federal Agency securities, state and local government securities, mortgage-backed securities, and money market instruments. Our statement focuses on foreign portfolio investment in the United States, and, in particular, the tax treatment of U.S. source income earned by foreign investors.

Foreign capital provides substantial liquidity to U.S. financial markets. In the U.S. Treasury market, for example, foreign institutions are major players, both as distributors of securities and ultimate investors. Foreign financial institutions often dominate Treasury auctions. With respect to transactions, in 1987, foreign investors made net purchases of $30.9 billion of Treasury securities; in 1988, foreign net purchases were $48.2 billion.[1] Foreign net purchases had already reached $44.6 billion through October of 1989. As a result of these and earlier purchases, foreign investors and international organizations held $393.5 billion of Treasury securities by the end of the third quarter of 1989.

This enormous flow of foreign capital into Treasury securities helps to make the U.S. government securities market the most liquid in the world and to allow the U.S. to finance its budget deficit at reasonable interest rates. A similar, though less extensive, story could be told for other U.S. capital markets. With respect to the public securities markets, foreign investors are becoming more important players in the market for mortgage-backed securities, and are clearly seen as a growth area for demand.

One attraction of U.S. securities to foreign investors is the favorable tax treatment of interest earned by foreigners on U.S. investments. Under current law, any U.S. source interest income earned by a foreigner and not connected with a U.S. trade or business is exempt from U.S. tax if it (1) qualifies as "portfolio interest," as defined in the Tax Code; (2) is paid on a bank deposit; (3) constitutes short-term original issued discount; or (4) qualifies for a treaty exemption. Withholding taxes on interest earned by foreigners were eliminated in 1984. Over the past few years, there have been proposals to reinstitute a withholding tax on U.S. source interest income earned by foreigners.

Such a proposal, if enacted, would impede the much needed flow of foreign financial capital into the debt-ridden U.S. economy. Instituting a withholding tax would make U.S. securities less attractive to foreign investors, who would demand a higher return as compensation.In the Treasury market, a higher return for foreign investors would translate into higher interest costs for the U.S. government, which would only serve to increase the budget deficit. In the mortgage market, a higher return for foreign investors would mean less potential for lowering the yield on mortgage-backed securities, and hence home mortgages, in the United States.

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In addition to increasing interest rates, a withholding tax would also tend to weaken the dollar, as foreign investors would have less incentive to invest in dollar-denominated assets. Although a weaker dollar helps to boost U.S. exports, it also tends to increase domestic prices (through higher-priced imports), at least in the short term.

Evidence that a foreign withholding tax would increase interest rates has already been provided by the financial markets. In 1987, when the financial markets learned that a withholding tax was included in a revenue options pamphlet prepared by the Joint Tax Committee, yields on Treasury securities rose significantly. The market calmed down a bit once financial analysts understood that the foreign withholding tax was only an option, not a proposal.

In sum, a withholding tax on U.S. source interest income earned by foreigners would tend to interest rates, create additional pressure on the budget deficit by increasing the cost of borrowing, and weaken the dollar, adding to inflationary pressures. Although the magnitude of such effects is difficult to determine precisely, it seems unwise to make any abrupt policy change that might impede foreign portfolio investment in U.S. securities when this investment protects the U.S. from the full consequences of its sizable debt.

Therefore, as the Committee considers the issue of foreign investment in the U.S., PSA urges that the Committee avoid measures such as a foreign withholding tax that discourage foreign financial investment in U.S. public securities.

Again, PSA thanks the Committee for the opportunity to testify on this issue.

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[1] All data from the Federal Reserve Bulletin, February 1990.

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Comments of Shippers for Competitive Ocean Transportation, SCOT,

on the implications of Europe 1992 on American direct investment in Europe and on foreign investment in the United States.

House Ways and Means Committee

Shippers for Competitive Ocean Transportation, SCOT, is an association whose membership includes a representative cross section of U.S. exporters and importers who route over 70% of all U.S. maritime liner exports and a significant volume of liner imports. SCOT represents U.S. shippers on issues involving cargo reservation or more broadly on actions that would limit a free market for maritime transport in the U.S. international trades.

Efficient transportation fully competitive with transport from other world suppliers is essential if U.S. exporters are to compete in all world markets and help reduce the current unacceptable unfavorable trade balance.

In the current maritime negotiations with the Soviets the U.S. negotiating team is led by MARAD, an administration whose primary responsibility is to promote the U.S. Flag Merchant Marine. The U.S. negotiating position, approved in 1987, would require imposition of cargo reservation in the U.S./Soviet trade, a position opposed by U.S. exporters and, we understand, by the Soviets. This policy would be particularly damaging to the U.S. farmer and to other bulk exporters. Grains account for 75% of current exports to the U.S.S.R.

SCOT feels the maritime negotiations is an example of a situation in which our policy has not adequately responded to the rapid change of events in the Soviet Union and Eastern Europe, and in which the pursuit of a goal by one branch of government may frustrate major objectives critical to the economy as a whole.

While the proposed cargo reservation provisions advocated by MARAD would initially affect bulk exports most severely, U.S. exporters feel that liner cargo sharing would, over time, lock the U.S./Soviet maritime relations into a cold war environment and frustrate the efforts of the Soviets to move toward a more open economy. Cargo reservation would adversely affect decisions of U.S. industry to make capital investments in the Soviet Union, particularly a joint project under discussion for development of oil reserves.

SCOT commends the Ways and Means Committee for recognizing the need for a review of all U.S. policies relating to the Soviet Union and Eastern Europe. It is critical that priorities be established and that coordination occurs to make certain implementation of one policy does not frustrate other more critical ones. It is our understanding that MARAD would propose to implement a similar policy of anti-competitive cargo sharing with all Warsaw Pact Countries. It would seem appropriate to consider what significance the Warsaw Pact has in the current political climate and particularly to evaluate if one policy is appropriate for all members.

With regard to Europe 1992, U.S. shippers are concerned that the further integration of the European economies will make an already formidable competitor even more effective. With regard to the Soviet Union and Eastern Europe, the countries in "Europe 1992" are already closer to the Soviet and Eastern European markets than the U.S. and most European countries have an overland route as an alternative to maritime shipment. In spite of this geographic advantage no Western European country, except Portugal, has imposed cargo reservation on their exporters in their maritime trades with the Soviet Union and Eastern Europe. Lack of competition in the U.S./Soviet maritime trades would encourage multinationals to invest in Europe, not in the United States, to serve emerging markets in Eastern Europe.

It is our firm conviction that a free and competitive maritime trade will best serve the economies of the United States and our Eastern European trading partners. It would be tragic if the U.S. imposed a backward looking regime in these trades that was counter-productive to the economies of our trading partners and to our exporters. If short term problems exist for U.S. flag carriers in a transition period they should be addressed in a manner that does not prevent the trading partner from moving toward a more market oriented economy. Cargo reservation in a maritime agreement of three years or more would seriously disadvantage U.S. exporters and would encourage uneconomic allocation of resources by the economies of both trading partners.

SCOT sincerely appreciates the opportunity to express the views of U.S. shippers on these important issues. If there are any questions we will be glad to furnish any additional information that is useful.

H. George Miller

H. George Miller
Executive Director, SCOT

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American Hotel and Motel Association
American Recreation Coalition
American Sightseeing International
American Ski Federation
American Society of Travel Agents
Association of Retail Travel Agents
Conference of National Park Concessioners
Gray Line Sight-Seeing Association
Highway Users Federation
Hotel Sales and Marketing Association International
International Association of Amusement Parks & Attractions
International Association of Convention & Visitor Bureaus
National Air Carrier Association
National Business Travel Association
National Campground Owners Association
National Caves Association
National Council of Area and Regional Travel Organizations
National Council of State Travel Directors
National Council of Travel Attractions
National Restaurant Association
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An Affiliate of
Travel Industry Association of America

February 20, 1990

Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

These comments are submitted with regard to the hearing held by the Ways and Means Committee on January 30, 1990, on trade relationships between the United States, the Soviet Union and Eastern Europe. We commend you and the Committee on your foresight in examining these evolving relationships at this early stage in what we all hope will be the post-cold war era.

The Travel and Tourism Government Affairs Council is a coalition of 33 national travel and tourism organizations. Its members represent every segment of the industry, including transportation, accommodations, food services, travel agencies, tour sales, attractions, recreation, and state and local travel and tourism officials.

Travel and tourism is now officially recognized by the Department of Commerce as this country's largest export. In 1989, international visitors to the United States generated more than $43 billion in foreign exchange earnings, more than agriculture, computers or any other export. As our largest export, we believe the concerns of travel and tourism should receive prominent attention in any trade negotiations between the United States, the Soviet Union and Eastern Europe.

Although economic conditions are likely to inhibit travel from those nations to the United States in the near future, it is still critically in our national interest to seek meaningful reciprocal tourism agreements. First, this will position our country to benefit from the enormous potential of those tourism markets in the longer term. Second, this will be in accord with our foreign policy objective of promoting economic development in those nations. Third, it will ensure that American tourism companies, such as hotels, tour operators, travel agents and airlines, can compete on an equal basis in the Soviet Union and

Eastern Europe with tourism companies from Western Europe and Japan.

Any tourism agreement should strive to accomplish several goals. It should facilitate travel by the citizens of both nations, either individually or in groups, by reducing burdensome and unjustified barriers or restrictions, such as unreasonable visa and customs requirements or currency exchange limits, to the maximum feasible extent. It should allow the tourism companies of one nation to operate fairly and equally behind the borders of the other nation. It should recognize that the freedom to travel is a fundamental right that transcends economic considerations to have an impact on the nature of politics and society. Enclosed is a copy of the "Open Borders Policy" recently adopted by the Travel and Tourism Government Affairs Council, which is a more generic statement of these same principles.

Thank you for your consideration of these points. Please let us know if we can provide any further information or be of any other assistance to you or the Committee.

Sincerely yours,

Aubrey C. King

Aubrey C. King
Executive Director

Enclosure

TRAVEL AND TOURISM GOVERNMENT AFFAIRS COUNCIL

OPEN BORDERS TRAVEL AND TOURISM POLICY

The Travel and Tourism Government Affairs Council supports the goal of "open borders" for travel and tourism among all nations. Peace, prosperity and democracy are advanced by policies that enable people to exercise their fundamental right to travel.

For the United States, an "Open Borders Travel and Tourism Policy" should encompass a realistic balancing of economic interests and public policy objectives that will maximize the ability and desire of citizens of other countries to visit the United States, enable American citizens to travel freely and efficiently in other countries, and allow travel companies to operate effectively at home and abroad.

All governments should strive to facilitate and encourage two-way travel flows across international borders and the transnational operations of travel companies. The ability of a people to travel to another country should be limited only under the most extraordinary circumstances.

Adopted February 7, 1990

USTOA

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ROBERT E. WHITLEY
PRESIDENT

Statement of the United States Tour Operators Association
Ways and Means Committee Hearing on the USSR and East Europe
United States House of Representatives
January 30, 1990

The United States Tour Operators Association is a group of US-based, mostly independent tour operators which account for a large portion of this country's outbound and inbound package tours. Because leisure travelers often visit a country the first time on an inclusive tour, tour operators play a principal role in developing destinations. West-East travel flows, which are expanding rapidly under current favorable conditions, will continue to be overwhelmingly comprised of group tours. Tour operators are also involved in large business group movements to meetings and conventions and incentive tours.

OPEN BORDERS POLICY

USTOA has espoused since 1983 an Open Borders Travel and Tourism Policy for the United States and other countries as a condition for healthy democratic market societies. We recommend that governments keep one eye on the traveler and strive to facilitate as free movement across international borders as is possible to facilitate international communication and understanding. We ask governments to keep a second policy eye on the conditions for travel companies to provide travel services across borders. These conditions are best met when government policy considers travel a human right and promotes free information flows and free and fair trade.

Thirty three of the nation's politically most active travel trade organizations adopted an Open Borders Travel and Tourism Policy at the annual meeting February 7,1990 of the Travel and Tourism Government Affairs Council. The nation's largest export industry is united that the principles of free travel flows and fair trade should inform economic, cultural, and political agreements with the Soviet Union and Eastern Europe.

> "The Travel and Tourism Government Affairs Council supports the goal of "Open Borders" for travel and tourism among all nations. Peace, prosperity and democracy are advanced by policies that enable people to exercize their fundamental right to travel.
>
> For the United States, an "Open Borders Travel and Tourism Policy" should encompass a realistic balancing of economic interests and public policy objectives that will maximize the ability and desire of citizens to travel freely and efficiently in other countries, and allow travel companies to operate effectively at home and abroad.
>
> All governments should strive to facilitate and encourage two-way travel flows across international borders and the transnational operations of travel companies. The ability of a people to travel to another country should only be limited under the most extraordinary circumstances."

INTEGRITY IN TOURISM

Because of the central importance of travel services as infrastructure for all trade and investment and its large size and good prospects, the travel and tourism sector should be prominently included in comprehensive economic and business agreements with the USSR and Eastern European countries. The tourism agreements hastily negotiated last year as political signalling devices with Poland and Hungary do not include systematic travel industry input and do not reflect our most basic needs. Neither do the recently negotiated exchanges, consular, and civil air pacts, though their central purpose is to facilitate travel flows. In fact, U.S. manipulation of travel flows via these agreements during the period of strained relations was mostly calculated to depress travel.

Administration policy officials met several times with representatives of travel trade associations in November and December 1989 to discuss how the travel and tourism sector will fit comprehensive economic and trade agreements with Poland, Hungary, and those other European socialist countries including the Soviet Union that are moving in the direction of market economies. The President's subsequent decision to divide primary responsibility for negotiations between the Secretary of Commerce and the United States Trade Representative complicates the already enormous problem of policy coordination among government agencies and with the private sector. The travel industry has a special problem in this regard as it is not as well organized as finance, agriculture and manufacturing to interface with the small and already overtaxed staff of USTR which has been given responsibility for the Soviet negotiations.

SUMMARY OF SPECIFIC POLICY RECOMMENDATIONS

Several ideas that apply equally to the Soviet and East Europe negotiations were submitted in writing and discussed with Commerce Department trade policy officials. Now that negotiating authority has been divided, they will be presented also to the USTR. They can be summarized as follows:

> Comprehensive Economic and Business Agreements with the USSR, Poland, Hungary, and other East European countries need to include Tourism Annexes or Side Letters to make certain they refer to the non airline travel and tourism industry...
>
> Tourism Agreements with Poland and Hungary that were signed this year were negotiated without travel sector input. They are inadequate and need to be substantially revised. The proposed USSR agreement needs to be vetted with the industry it is intended to represent...........................
>
> Freedom of Travel - should be recognized in a comprehensive trade and economic agreement as a human right that can be realized only when adequate travel services are provided. Given the dismal records of both sides during the containment perior of strained relations, governments must pledge to uphold that right in major agreements that govern economic and political relations.........................
>
> Reasonably Free Conversion of Currency by travel companies and travelers needs to be assured in the transition era by a mechanism defined in the economic agreement..............
>
> Commercial Access of US firms to acquire and provide travel services on the territory of the other country can best be assured by including a mechanism to enforce reciprocity..

A Bridge to Aviation Bilaterals is necessary and provision for resolving conflicts between aviation and other travel and tourism services needs to be included in the general economic and business agreement..................

National Tourist Promotion Offices The existing tourism agreements do not address the main problem that conflict of interest makes commercial firms unfit to serve as the information offices of National Tourist Offices. ....

The travel and tourism sector needs to be featured as a central concern in Annexes or side letters of comprehensive economic and business agreements.

The United States and other developed countries increasingly are inserting provisions for services in bilateral and multilateral agreements. Travel and tourism services increasingly are being recognized as the dominant industry in the burgeoning services sector. The economic category of travel and tourism is best viewed for the purposes of international trade policy as trade and social infrastructure at least on a par with postal services and telecommunications. The world's investors and traders are by necessity the world's most frequent travelers. However, most American economic and trade policymakers err by equating all travel with recreational tourism which they regard falsely as an economically expendable luxury.

The fragmented travel and tourism "Industry of industries" at $2 Trillion in annual revenues has developed into the largest industry in the world. Travel and tourism services are the largest component of United States', Poland's, and Hungary's international trade, and they could be also for the USSR. Government travel controls designed to signal displeasure with aggression, to contain communist countries, and to and limit their economic development have severely limited transatlantic travel flows which in turn have limited other trade which is dependent on the travel and tourism sector to provide convenient and reliable face-to-face communication among commercial actors.

Democracy is grounded on the human right to travel to learn and to communicate. Travel is an infrastructure service like telecommunications and postal services. As such it is a precondition of markets and democracy. The travel activity and the travel industry need special protection from political manipulation. The U.S. government severely restricted West-East travel flows during the last decade in reaction to the Soviet invasion of Afganistan, the downing of Korean Airlines flight 007, and the repression of Solidarity. USTOA testimony in 1982 before the Senate Foreign Relations Committee on the severe negative impact of US travel embargoes and boycotts on US travel companies has become a classic in embargo literature. The restrictions on travel caused more damage to American companies than to the target countries and lessened American influence over the minds of East European citizens.

In contrast, Western Europe and most other countries have consistently followed an Ostpolitik policy of promoting and facilitating two way travel flows. The European Community, rather than the USA, offered face to face confirmation of democratic capitalism's superiority as a political economy. The principle demand of East European citizens has been to pull the walls down to allow free travel across international borders.

Because the political temptation to restrict East-West travel has been so strong on both sides, information on travel flows and travel services so poor, the concept of trade in services so new, the composition of the travel and tourism sector so fragmented and complex, and the average travel business so small, economic and trade policymakers are only slowly beginning to appreciate the central importance of travel to economic and commercial relationships among nation-states.

Trade in travel services differs significantly from other forms of trade in the important sense that the objects which are moved around, housed, fed, informed, entertained, and otherwise sustained are human beings endowed with human rights. Because most travel services are provided and consumed on the spot, it is important that the national providers of travel services have the opportunity to provide them within the countries visited by national citizens. Travelers are simultaneously consumers of travel services and performers of economic and social services in other economic sectors. When an American citizen enters Hungary, Poland, or the Soviet Union; America enters in a more significant way than when other physical objects or mental constructs cross the border.

The interagency drafting teams for the Polish, Hungarian, and Soviet Agreements are using the new Bilateral Investment Treaties (BITs), and the old Friendship, Commerce and Navigation Treaties as references to prepare concise documents built around a few key principles to apply to all industry sectors except those like aviation which are regulated in separate bilateral agreements. Should the Poles, Hungarians, and Soviets also wish to place other travel and tourism services on the negative list of excluded sectors, all the worst fears expressed by this and other travel trade associations to this Administration would be realized. We urge the Administration to insist on inclusion of all non airline travel services in comprehensive economic pacts

USTOA members had hoped that recent progress in defining the service sector and its principal components in the OECD, GATT, and the US-Canada Free Trade Area would result in a positive list agreement that, ideally, included a travel and tourism annex. A second best solution would be to include an exchange of letters which defined the travel and tourism industry components covered by the agreement and harnessed the separate tourism and transportation agreements to the larger enterprise.

An exchange of letters is less satisfactory a solution than a travel and tourism annex, but it would lessen the ambiguity of three overlapping agreements relating to a poorly understood and underrated industry.

Both the 1989 Polish and the Hungarian tourism agreements were negotiated in a vacuum by USTTA and State Department officials who did not systematically solicit input from the travel trade associations and travel company area specialists known to them as interested parties. The Commerce Department's Industry Sector Advisory Board, Travel and Tourism Advisory Board, and Tourism Policy Council collectively proved ineffective mechanisms to coordinate with the main players in the specialized U.S. - Eastern Europe travel industry. The private sector was for all practical purposes excluded. Once signed, the agreements were not disseminated or discussed with the principal commercial actors or their trade associations and they remain insignificant mystery documents to the private sector to this day. The trade agreement consultation process which informs other trade negotiations was not undertaken resulting in tourism agreements that do not reflect the greatest industry needs. Similarly, civil aviation, exchanges, and consular agreements have been negotiated without methodical attempts to obtain input from the travel companies that make travel flows possible. The spur to negotiation of these travel facilitation agreements was politically motivated, placing them in the "signalling device" category.

The inadequate process for negotiating tourism and other travel facilitating agreements in the last several years is a strong reason for including travel sector trade problems in larger trade agreements. The master agreement should refer to the lesser, subsidiary agreements and tie them in to the organic whole.

The substance of the consular, exchanges and tourism agreements is mostly benign. The principal harm to US travel trade interests lies in the predisposition of economic and trade policymakers to place the innocuous documents on the shelf as trivial agreements out of the main stream of economic and trade arrangements. The perception problem is exacerbated because civil aviation bilaterals have enormous teeth. They overwhelm the tourism bilaterals and work to the advantage of countries where collusion exists between a dominant airline and a dominant land service company.

Each of the tourism agreements, which do not even attempt to define the travel and tourism sector to which they apply, reflects the mild content of the other 10 or so bilateral tourism agreements of the United States. They deal with rules for official tourism promotion offices, facilitation measures such as government consultation, medical treatment, importation of promotional literature, and customs procedures. The governments agree to exchange information on travel flows and laws, and establish non-travel industry forums for the private sector to discuss inevitable problems. The parties designate industry forums and agree to facilitate tourism education.

Travel and Tourism Annexes - should be included in comprehensive trade and economic agreements.

The pioneering US-Canada Free Trade Agreement defined the travel and tourism sector in an annex which specified that the generalized rules for trade and investment for other sectors except for aviation apply also to travel services. The "Canadian" definition needs to be expanded to include computerized reservations systems (CRS) which comprise a high technology industry in their own right. CRS is becoming a principal marketing and travel management tool in international travel sector competition.

The agreement also spells out liberalized and harmonized rules for temporary work by the nationals of each party on the territory of the other. Visa documentation might be the greatest single obstacle to travel flows and travel trade between the United States the Soviet Union and Eastern Europe.

A principal objective of the European Community barrier free common market by 1992 is to facilitate travel flows for work and leisure. The Soviet Union, Hungary and Poland are economically closer to the EC trading bloc than to the United States and they probably will have to adapt to the high new standards under development there for international trade in travel services. It would be strategically wise for the United States to anticipate the defacto and dejure relationships that are developing within the Eastern and Western European economies for the travel and tourism sector. The model for the tourism annex or exchange of letters, in other words, should anticipate conditions likely to exist tomorrow because of the huge pull of the EC which is the largest and richest travel market in the world. Also, Germany and the EC are providing Marshall Plan type economic reconstruction assistance which dwarfs the American effort at a time that market dominance is being decided. West European public money will be convincing in the current economic crisis, and it will favor European firms over their American competition.

The comprehensive agreements under consideration at least offer the opportunity to anticipate events in Europe and to act first to ensure U.S. economic participation and influence in the rapidly evolving Polish, Hungarian, and Soviet economies.

Freedom of Travel - should be recognized as a human right that can be realized only when adequate travel services are provided.

Freedom from political manipulation of travel is assumed in the US-Canada Free Trade Agreement because of the North American political economic culture which emphasizes free trade and human rights. America's historical experience with communist countries of Eastern Europe has been marked by travel controls and severely limited commercial privileges. A brief declaration is warranted that travel is a human right and an essential trade infrastructure service and that both governments pledge to continue to facilitate travel and travel services during inevitable changes of political weather. The Shanghai communique and the US-China Tourism Memorandum of Understanding are instructive on this point. The political weather has worsened but both governments have mostly lived up to their agreements not to interdict travel. Similarly, 20-20 hindsight shows that Western Europe rather than the United States has had most influence on the democratization and marketization of Eastern European countries because their travel contacts were far more stable and strong than ours. The United States needs to renounce travel embargoes as economic weapons by international economic agreements which include pledges by socialist countries like the USSR, Hungary, and Poland to refrain from imposing political restrictions on their citizens visiting the United States.

Reasonably Free Conversion of Currency by travel companies and travelers needs to be assured in the transition era by a government mechanism defined in the economic agreement.

Current Soviet and East European government practise prevents effective US company activity on their territories by not allowing conversion of soft currency earnings to dollars that can be exported, and limits Polish travel to the US by restricting the amount of dollars a traveler can purchase and export. A grave financial crisis engulfs all the state trading economies. US banks, who lent unwisely to "sovereign" communist governments, have priority claims on future earnings. Without protection, a trade and investment agreement that unilaterally opens the United States to profit taking will be as biased against U.S. travel companies as the current unsatisfactory hodgepodge of transport, tourism, trade, investment, and financial arrangements.

Some bilateral mechanism needs to be devised to replace unilateral currency rationing systems which give highest priority to banks and East Europe's travel companies and lowest priority to US travel companies. Because payments for travel services will continue to flow mostly from the US to the USSR and Eastern Europe, maintaining existing unilateral currency discrimination on repatriating the earnings of US companies operating in Eastern Europe would effectively maintain the status quo whereby only their travel companies continue to freely expand into our origin and destination. The surest way to frustrate American investment in travel services is to inadequately patch over this difficult problem.

Commercial Access - of US firms to acquire and provide travel services on the territory of the other country.

The thrust of America's recent bilateral and multilateral trade negotiations has been to define generalized rules of trade and investment that apply equally to travel companies as they do to providers of financial services and manufacturers. Because travel has been managed as a public utility in the USSR and Eastern Europe and because of its political significance as a precondition of democracy, restrictions on the operations of American travel companies there have been especially severe. The huge state controlled travel monopolies have provided almost all travel services for foreign visitors in their domestic market while they used their monopoly position to divide and rule among many foreign companies to extend their travel services into the distribution systems of capitalist origin markets like the United States.

The USSR, Hungary, and Poland are moving from Point A of national travel monopoly to Point B of US style free trade and investment by many competing firms. However, it is naive to believe they will ever reach the US laissez-faire extreme because these are European socialist countries embedded in a larger European culture that is comfortable with strong government management of travel services as public goods. Western European countries have rejected the US laissez-faire travel system model and are maintaining much more direct government control over their travel economies. US commercial access to the Hungarian and Polish travel sectors needs to be facilitated in bilateral agreements.

Reciprocity -must be a cornerstone principle during the transition period of the USSR and Eastern Europe to healthy market economies.

Guarantee of commercial access must go beyond a declaration of national treatment or most favored nation treatment. Because socialist countries have a long history of state control over their travel economies which are organized by different principles, it would be naive to assume that they will all at once agree to do everything the American way. The principle of reciprocity is the basis for aviation and maritime agreements which will coexist with any general economic and business agreement. Reciprocity is also the key concept in the US-China Tourism Memorandum of Understanding. A brief statement needs to be included that the United States will permit their travel companies access to US markets in proportion to their granting similar access to US travel firms in their countries.

The declaration of reciprocity needs to be backed up by a government consultation and grievance settling mechanism such as exists in the US-Canada Free Trade Area.

The concepts of national treatment and most favored nation treatment need to be reciprocally enforced and the arbitration foreseen in bilateral investment treaties may not be up to the task. There will be resistance during the transition period to opening their travel sectors to American companies while Polish and Hungarian travel companies, which already enjoy national treatment, expand their established travel businesses in the United States. Mostly their side achieved market penetration under existing agreements that discriminate against US travel companies, and embargo policies which weakened many small private US travel companies relative to the comparatively huge State owned and subsidized travel monopolies. They have little incentive to change existing practise to facilitate US company penetration on their soil. Certainly, freer markets would increase the total pie but unfree, unilaterally regulated travel markets will preserve most of the pie for the East European travel companies that dominate the principal destination. Severe disputes will require decisive action by US government authorities. They will need to rely on institutional leverage inherent in the concept of reciprocity built in to consultation and dispute mechanisms. A US agency should be mandated to restrict their commercial activity to the level that they establish for US companies on their soil, keeping in mind not only the benefit to US travel companies and travelers, but also the hemorrhaging US bilateral travel account.

A Bridge to Aviation Bilaterals is necessary, and provision for resolving conflicts between Aviation and other travel and tourism services needs to be included.

Airlines are strictly regulated in bilateral agreements whereas land transportation and other forms of travel services like travel retail sales, tour operations, food, lodging, entertainment and conference facilities, computerized reservations systems and travel payments systems have mostly been ignored in broader commercial agreements. Tourism Agreements have insufficient teeth so aviation policymakers make tourism policy via aviation agreements to suit the needs of airlines rather than the needs of travel systems or national travel destinations.

However, airline companies are in reality multinational travel service companies. They do not just provide aviation services, but have used their privileged regulated path into foreign travel markets to enter other sectors of the travel and tourism industry that are theoretically governed by another, more liberal set of rules for trade and investment. In 1988 the Department of Transportation granted a Soviet-US aviation cartel a monopoly on direct air service and then granted the monopoly unprecedented anti-trust immunity to sell and provide land tourism services in the United States. That precedent which is destructive of free markets in travel services hovers over the travel industry throughout Eastern Europe. The Department of Transportation in 1989 granted the Polish foreign travel monopoly Orbis (which also mans the official tourism information office and a land services commercial office in the United States) charter rights even though the Polish government will not provide effective charter rights to the largest US tour operator.

This conflict between the managed trade basis of aviation and maritime and the free trade basis of other travel and tourism services is an unresolved core weakness of the current GATT negotiations and the US-Canada Free Trade Area. Government agencies try to avoid the issue which importantly reflects on the bureaucratic power of entrenched agencies. The trend however, is to move from managed trade to free trade, and from transportation services regulated by individual modes to transportation systems that are integrated in broader travel and logistics systems. The itinerary, not the airline seat, is increasingly the policy focus once transportation infrastructure is built and governments need to focus more on how to manage complex travel systems.

Conflicts between airlines and other travel and tourism sector interests need to be resolved in the interagency/private sector forum of the larger comprehensive economic and business agreement rather than in aviation bilaterals. A formal mechanism is required for the government and the economy to prevail over narrow aviation interests. Existing compartmentalized institutions will continue to undermine the competitiveness of the US travel sector and the larger trade and investment enterprise of the nation.

> **National Tourist Promotion Offices** The existing tourism agreements do not address the main problem that commercial firms are unfit to serve as the information offices of national tourist offices.

The Orbis and Ibusz commercial travel companies at present represent their tourism ministries as 'information' offices though the normal practise is for the national tourism ministries of other countries and the United States Travel and Tourism Administration to be represented abroad in person by officials of the government agency. There was confusion in the past about whether it really made a difference whether a communist tourism ministry or the state commercial monopoly manned the tax free "information" office. History has shown that commercial enterprises when given the status and privileges of government agencies, will abuse that leverage to promote their commercial interests. The USSR and East European travel companies have sold travel services from tax free national tourist office information offices.

Naivete about the need to separate commercial fulfillment from government policy and promotion tasks was understandable in the distant past. Under current conditions of marketization of these economies, allowing commercial firms to continue to perform in the United States as agents of the government is tantamount to the United States Travel and Tourism Administration delegating American Express or Ask Mr.Foster to represent the US government in London. The conflict of interest has been so great in the last two decades that the Polish, Hungarian, Soviet, and other Eastern European tourism information offices have engaged in direct travel sales.

The United States eliminated the problem with China by suggesting that country's National Tourist Office to send its own people to man the information office. The precedent worked and it should be applied to those other socialist countries which have not yet converted their information offices from commercial company to government tourist office representation.

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Statement by Cord D. Hansen-Sturm
Ways and Means Hearing on the USSR and East Europe
United States House of Representatives
January 30,1990

My name is Cord D. Hansen-Sturm. I am the President of the consulting firm Visitor Industrialists Corporation, 1 Lincoln Plaza, Suite 11F, New York, NY 10023. I have spent a career in public and private service as an expert in economic war. I have conducted studies in and out of government on the impact of embargoes and boycotts especially on travel markets.

Travel is a fundamental human right that is a necessary condition for the operation of market-based democratic society. Travel services are infrastructure for all other forms of trade and social communication. Travel controls and other barriers to travel reduce communication. Travel controls are the principal instrument of totalitarianism, thus freedom to travel is the first demand of peoples who desire democracy.

The United States, as the superpower guardian of democracy, has intemperately used travel as a political and economic weapon in its broader policy of containment of communism. I have learned from painful experience that Americans are reluctant to deal with the issues of economic war that conflict with their idea that this country's policies always promote free flows of goods and services, people and ideas. The tendency is to sweep embargoes under the historical rug, and thus not to learn from our mistakes.

The motivation behind this short statement is to encourage better congressional oversight over the executive's use of travel embargoes and boycotts. It is easy to turn off travel flows, as the US record with the Warsaw Pact countries illustrates too well. It is much harder to normalize conditions for travel. Businesses that provide travel services are destroyed and others are not created during embargoes. Expectations of business people linger after embargoes and boycotts that government will interfere again in the future.

As long as the American public mistakenly believes that economic war caused Communism to implode, policymakers in future political conflicts will continue try to turn travel trade on and off as if it were a political faucet. Anticipating this, American business will mostly avoid investment in the USSR and East Europe.

Travel trade has suffered more than any other category of East West trade in the last decade. As a result, almost all Americans have no direct experience of East Europe and the Soviet Union. It is not difficult to predict how little influence Americans will have in the region now that competition is economic rather than military, now that knowledge rather than patriotism is the necessary foundation of policy.

Recognizing this, thirty three of the nation's most politically active travel trade associations have taken advantage of the current detente and adopted an Open Borders Travel and Tourism Policy. It is based on the ideas that travel is a fundamental right that can be exercised only when governments allow travel companies to provide travel services. East Berliners can walk to West Berlin, but Muscovites must fly to Washington.

The White House and the State Department have devised a battery of travel weapons that operate beyond traditional Congressional oversight of legislatively authorized embargoes. The Export Administration Act and the International Emergency

Economic Powers Act, like the Trade Act which swaps goods for visas, at least keep Congress involved. Now that travel is being normalized with the communist superpowers and it has become obvious that no legitimate state of emergency threatening national security exists between the United States and any country, it is inevitable that Congress will encourage the executive to lift the IEEPA bans on travel to Vietnam and Cuba.

But will Congress take action to prevent future abuse of the embargo instruments most frequently employed during the 1980's economic war against the Warsaw Pact countries? Consular, Exchanges, Civil Aviation, Maritime, and Tourism Agreements all have the common central purpose of facilitating travel flows. Turn them around and they obstruct. Nowadays, when the State Department wishes to restrict travel to a target destination, it slows travel documentation, eliminates exchanges, regulates flights and port calls down to zero, and stops producing data on travel flows to prevent an informed political opposition from forming. The above listed travel embargo measures should be monitored in formal annual reviews by the Trade and Foreign Policy Committees of Congress, but they have not been and will not be in the absence of data that no agency seems willing even now to collect. As an experiment, this committee should ask the State Department to provide detailed bilateral travel data with the East European and Soviet countries for the recent decade.

The most potent travel weapons of all are the President's "Bully Pulpit" and the State Department's travel advisories. On January 2 1980 President Carter reduced travel to the Soviet Union and Eastern Europe to a trickle by asking the world to boycott the Moscow olympic games. Only Americans obeyed him, but travel to the region from the United States was decimated along with the specialized American travel companies on which future potential travelers were dependent. Congress bailed out farmers whose grains were embargoed on the grounds that no single constituency should bear the brunt of economic war. Travel companies were left to languish and die.

President Reagan combined travel embargoes with constant appeals to boycott the region. During the Reagan era, the White House began to lie to Americans to keep them home. The KAL 007 travel cordon was based on the [illegible] propaganda assertion that the U.S. had proof the shooting was deliberate aggression. The State Department said, untruthfully, that it was unsafe to fly to Moscow from Europe. Other nations ignored the call "to isolate the Soviet Union from the civilized world of aviation", but Americans believed and obeyed.

The State Department from that moment began to issue a series of travel advisories falsely warning the American public about non-existent dangers and inconveniences making travel hazardous in the Soviet Union. I attended three travel industry meetings with ranking State Department officials in the early 1980's that led ultimately to a policy that travel advisories tell the truth. By that time, however, the idea that false advisories were legitimate political weapons had gained credence in Congress. Pressure mounted for legislation in 1986 that would have required the Department of State to declare travel unsafe to countries sponsoring state terrorism abroad, even though their own territories were perfectly safe to travel in.

For these several good reasons, the oft-burned American travel industry is more reluctant to risk involvement in the USSR and East Europe than the West European competition.

- **The travel industry seeks clauses in the comprehensive economic agreements under negotiation that the participating governments pledge to facilitate visits as a fundamental human right.**

- It seeks assurances in these broad economic and business pacts that the several separately negotiated consular, exchanges, aviation, maritime, and tourism agreements are treated in the future as integral components of an organic whole whose purpose is to make continuous reliable communication via travel possible rather than to prevent travel as a political signalling device or a weapon of economic war.

- To overcome the tendency of policymakers to treat travel as nonessential recreation, they want the travel industry to be defined in major political and economic treaties as communications infrastructure like telecommunications and postal services on which all other forms of trade and social intercourse depend.

By effectively restricting travel under the policy of containment, the United States government has mostly isolated America rather than the USSR and Eastern Europe. In stark contrast, West European governments advanced the causes of democracy, prosperity, and peace by encouraging trade and tourism instead of limiting them. Europeans rather than Americans served as the principal models for the revolution that altered East Europe's collective mind.

History tends to repeat itself. Now is the time that Congress can help create a legal basis for stable travel flows to the USSR and East Europe. Without the assurance of treaties and domestic law, travel markets will remain suspicious the government will intervene at the inevitable onset of worsened political weather.

Submitted for the record:
Testimony on Foreign Direct Investment
Ways and Means Committee

JAPANESE INVESTMENT IN THE U.S.: AMERICAN RESPONSES

ECONOMIC OVERVIEW

Text of speech given at the
Edwin O. Reischauer Center
School of Advanced International Studies
The Johns Hopkins University

November 15, 1989

CYNTHIA DAY WALLACE

Center for Strategic and International Studies

JAPANESE INVESTMENT IN THE U.S.: AMERICAN RESPONSES

Economic Overview

The title of today's seminar, "Japanese Investment in the United States: American Responses," will undoubtedly evoke a variety of comments from the floor as well as from the various panel members throughout the day.

I must begin by disabusing you of any expectations that Kent's fine introduction may have given you, of an "in-depth" presentation. Since in-depth coverage of so vast a topic as the U.S.-Japan investment relationship would be impossible within 25 minutes, my aim is to provide, as the program indicates, an economic overview, with a bit of historic perspective, to set the stage for the day's proceedings. It is indeed a pleasure to speak on this particular subject which has become one of the top priority items on the international economic agenda of the Bush administration.

There is, of course, no single unified response in America, no overall consensus on the Japanese investment question. The very lack of consensus among Americans is well summed up in a remark made recently by a California professor of Pacific Studies who put it in a good news/bad news scenario: "The good news is that the Japanese are investing heavily in America. The bad news is that the Japanese are investing heavily in America."

Two main reasons for the heightened focus on foreign direct investment in general and on Japanese investment in particular are, firstly, our hypersensitivity over the twin deficits and the role that is played by the Japanese trade imbalance in that area and, secondly, simply the very dramatic increase in Japanese investment in the United States.

The 1988 figures from the Commerce Department show that for the first time since World War I, the United States is in a net deficit position with regard to foreign direct investment flows. We must, of course, always keep in mind the difficulties in accurately measuring direct investment, based as it is on book value rather than market value, and based on long-term cumulative figures with the inherent inflation and exchange rate variables.

But whatever the uncertainties in data collection, the trend is clear. The 1988 figures show $2 billion more worth of assets directly invested in the United States than U.S. assets invested abroad. Directly invested foreign assets in the United States totaled $329 billion as opposed to $327 billion of U.S. assets directly invested abroad. This represents nearly a quadrupling of the amount of foreign direct investment in the United States between 1980 and 1988 (Table 1).

During the same period, there has been more than an elevenfold increase in investment from Japan into the United States. By 1988, nearly half of all Japanese investment abroad was located in the United States, up from a third, four years earlier (Table 5). Between 1986 and 1988 alone, the United States saw an approximate doubling of Japanese direct investment (Table 2). Of all foreign investment in the United States, 16 percent of it comes from Japan (Tables 3 & 6) as compared with 6 percent in 1980. By contrast, only 5 percent of all U.S. investment abroad currently goes to Japan (Tables 4 & 7), up less than 3 percentage points since 1980.

In monetary terms, the amount of Japanese vis-a-vis total foreign direct investment flows into the United States rose from $4.7 billion out of a total $83.1 billion in 1980, to $53.4 billion out of a total $328.9 billion in 1988 (Table 6). In the same period, U.S. direct investment gaining access in Japan vis-a-vis total U.S. direct investment abroad rose from $6.2 billion out of $215.4 billion in 1980, to only $16.9 billion out of $326.9 billion in 1988.

Some country comparisons showing current balances between outward and inward U.S. investment (Tables 8 & 9) reveal fairly dramatic imbalances with our four largest investment partners: Britain, Japan, the Netherlands, and Canada. The imbalances disfavor the United States in relation to the first three named, and are in the favor of the United States with regard to Canada. A fair equilibrium is displayed with West Germany.

The figures show very little increase in U.S. direct investment abroad for each of these countries between 1987 and 1988. In fact, for West Germany there is even a slight decrease. The two dramatic pictures on investment into the United States are Britain and Japan, with $18.2 billion and $22.2 billion one-year increases, respectively (Table 9).

You cannot look at direct investment figures, showing the United Kingdom with nearly $102 billion as against $53 billion for the Japanese, without asking--if you haven't already asked and answered this question--why so much focus on Japan? The British have nearly twice as much direct investment in the United States as the Japanese, and they outperformed Japan by $4 billion over the last year for which investment figures are available.

Well, the fact is that Japan is actually already in first place in a number of areas:

o Japan is number one in terms of the total number of companies investing in the United States, and has been since 1985.

o Japan is number one in terms of sales by its subsidiaries. (Japan was well in the lead by 1986 with $165.7 billion, followed by Britain with $113.5 billion and thirdly, by Canada, with $82.6 billion.)

o Japan has been rated first in international economic competitiveness in a recent international survey by two Geneva-based concerns. (Out of 32 countries assessed, the Swiss survey ranks Japan as number one, Switzerland as number two, and the United States as number three.)

o Japan is number one in the rate of increase in direct investment (Table 10), with a 35 percent growth rate measured over the period 1985 to 1988. This is approximately the same as its growth rate over an earlier period, 1980 to 1984, which was measured at 35.8 percent. (Second in line in rate of increase is the United Kingdom with 27.6 percent over the period 1985 to 1988, down from 36 percent over the earlier period. If the rates of the United Kingdom and of Japan were to remain constant, by 1995 Japan would have moved into first place in cumulative terms as well as in these other categories.)

"Well," you might say, "what is so wrong with being number one? What is so sinister about being number one?"

There is nothing intrinsically wrong with being number one. But the fact is that there are a number of areas of friction that have turned a focus on Japanese investment, the rapid increase of which makes the possible outstripping of cumulative British investments appear ominous to some Americans.

One of the reasons for the focus is simply the sheer rapidity of the rate of increase itself. Another is that frictions already existing in the trade area may have been simply transferred to the investment area, even before Japanese investment was targeted as potentially problematic. Thirdly, there is high visibility of the product lines that are invested in by the Japanese, particularly consumer electronics. This heightens the awareness of the American public as to the extent of investment by the Japanese. Our television sets, our VCRs, our camcorders, our cameras, and so on, have high visibility where we live. Differences in business practices have served as a further source of friction.

Surely of all the areas of friction, the key area relates to the perceived imbalance between the receptivity of the United States market to Japanese investment vis-à-vis the receptivity of the Japanese market to foreign investment. Some of these perceptions arising from Japanese investment activity, while they are changing, often take some time to dissipate.

Moreover, it was felt early on--and the Europeans have echoed this as well--that many of the Japanese investments were in the form of assembly plants (so-called "screwdriver" operations) without much transfer of technology or local R&D.

Less than a year ago, I was talking with a businessman who was describing this particular feature of Japanese investment. I said: "You mean, a little like a rainbow? The U.S. plant is situated here, the mother plant is situated over in Japan, and nothing touches in between?" He answered: "Yes, and the pot of gold is at the other end."

I have since referred to this as the "rainbow effect"--that perception that little of the Japanese enterprise touched the host economy. As I mentioned earlier in the context of market access, such perceptions die hard. But as the "rainbow effect" is indeed subsiding, some of these perceptions must begin to change as well.

While Kissinger once said that perceptions often become realities, the reverse is also true--that perceptions usually have their origins in some source of reality. It would be false to pretend that these impressions are totally unfounded. But there is a noticeable change, and this should be publicized. Continuation in the direction of increased shared technology by the Japanese--and dissemination of the news--will go some way in improving this image.

Such contributions as "The Japan That Can Say No" regrettably do little to further the cause. Mr. Ishihara, in provocatively promoting technology denial to the United States, should recall that Japanese technology was originally supplied by the United States, and at no cost to Japan. The Japanese have, to their credit, gone from being imitators to being innovators and inventors. Some degree of return in kind, where corporate confidentiality is not breached, would go a long way in alleviating U.S. objections. The U.S.-Japan investment relationship ought to be a symbiotic one.

I have been particularly impressed, both here and in Japan, with the sensitivity of the Japanese to American reactions. I find the Japanese to be non-confrontational. They are disinclined to engage in hostile takeovers. The Japanese want to feel welcome. They are asking the right questions and are making moves in the direction of accommodation and cooperation. It has taken some pressure to achieve this, but a number of the Japanese I have listened to invite such U.S. pressure as a necessary part of the process.

Direct investment policy is meanwhile seeing some advances in concrete terms within Japan:

o Tokyo reports that new investment in Japan in fiscal year 1988 was 46 percent greater than the previous year.

o The Japanese Ministry of Finance recently announced new measures to deal with investment friction.

o The Japanese are rewriting the rules to make American-style mergers and acquisitions more acceptable in Japan, to make takeovers easier.

o There is evidence, as I mentioned, of more R&D sharing, more technology transfer, more value added.

o We are all aware of the structural impediments initiative (SII) talks that are going on right now, bringing Japanese and American negotiators together over some of the more troublesome issues.

o Japan vastly liberalized its investment rules in 1976, though there has characteristically been a significant lag time, historically, between new initiatives and the anticipated reforms; and there is not always the awaited marriage between new policy and practice.

Where there is discontinuity between promise and fulfillment, this in itself fosters disillusionment and frustration on the part of those trading partners anticipating the proclaimed reforms. This can contribute further to existing frictions. The very necessity of the SII talks themselves is one indication that the liberalization of investment laws did not, in fact, solve all of the practical aspects of penetrating the Japanese market and doing business in Japan.

While there is hope that the SII talks will achieve some positive results, much skepticism carries over from past disappointments. It must at the same time be remembered that changes in Japan proceed much more slowly than in the United States. Care must be taken, in this regard, that expectations are similar on each side, as to the timeframe for anticipated outworkings of the talks. Otherwise, only more friction can be anticipated.

It is useful to spend a moment on the public reactions in the United States to Japanese investment, partly because of popular sentiments expressed over recent acquisitions of Columbia Pictures and of Rockefeller Center by Japanese interests. Such acquisitions do create an emotional or visceral reaction on the part of the American public, even if largely divorced from pure economic considerations.

We know from a public opinion poll taken last year that while a very high percentage of the American public was favorable to some sort of restriction on investments (about 78 percent), that an even higher percentage (some 86 percent) of what was termed the "elite" (which I prefer to call "informed decisionmakers") recognized the economic benefits of Japanese and all direct investments in the United States and, in fact, opposed restrictions.

One does, then, look at the emerging legislation from Congress and the apparent protectionist sentiment there, and one says "if such a high percentage of the governing 'elite' is against restrictions, why the tendency toward restrictive--or at least relatively restrictive--legislation hovering in the halls of Congress?"

Part of the reason, of course, is the American public's reaction. These are the constituents back home. I was asked in Tokyo recently why, if so many decisionmakers in Washington are against restrictions, they don't try to persuade their constituents of their own persuasion. Realistically, such a mission is not normally high on a Congressman's list of priorities. So this task is left to those outside of government, like myself, who are trying to better publicize the benefits of the unhindered flow of direct investment--Japanese or otherwise--into the local economy.

There certainly is a serious need to counteract some of the more blatant media hype and inform the American public of the intrinsic benefits of foreign direct investment, from whatever friendly nation. It is not an easy task to compete with the mass media and sway public opinion; but such is needful, not just for U.S.-Japan relations, but for the sake of the economic well-being of the nation.

An opinion poll that was taken among three states with very high levels of Japanese investment: California, Michigan and Tennessee, displays considerable agreement that Japanese direct investment is, in fact, good for the American economy (Table 11). There is an even more dramatic display of agreement in the poll--and the employees of Japanese companies are the highest on this count--that Japanese-affiliated companies have caused American manufacturers to become more competitive.

A majority of respondents in a similar poll (Table 12) does believe that foreign direct investment creates new jobs. A majority does believe that it brings the best of foreign business techniques. A majority does believe that it creates more competition leading to lower prices. A majority is even against prohibiting, altogether, further inward investment. Yet a dramatic 89 percent of the respondents in this second poll believe that some degree of registration, or some higher degree of monitoring and registration, is desirable.

The country breakdown in Table 12 gives a notion of how the Japanese measure up in the eyes of the public. On business effectiveness, they get a very high rating. A significant 43 percent believe that Japanese employers treat their workers well. (Another poll rated the Japanese number one as foreign employers.)

In the area of trustworthiness, however, it is our old British friends who take the lead. And of all the areas of friction with the Japanese, perhaps the key one is the sense of unfairness. This shows even more clearly in another poll (Table 13) where Japan's rating on fairness, measured against six other countries, is only one percentage point above the Soviet Union, the lowest on the scale. And in the "unfair" column, Japan received a 60 percent rating, while the Soviet Union, as runner up, received no more than 44 percent. (The "unfairness" scores ranged from 9 percent, for Canada, to Japan's 60 percent.)

The favorable rating on treatment of workers by the Japanese, as seen in the previous poll mentioned, would indicate that this "unfairness" is not in employment practices or in the employer-employee relationship. The unfairness judgment here presumably comes rather through the filtering down, primarily through the corporate/worker grapevine as well as through the media, of a strong sense of imbalance in market accessibility or of unequal treatment of U.S. companies in Japan.

In the course of discussions over these and other issues with the Japanese, U.S. negotiators have shifted away from the concept of reciprocity, because reciprocity technically says: "if you don't, we won't"; and we wanted to [keep our markets open]. Nonetheless, we also wanted to experience open markets for our own investments in Japan, so we moved from the notion of mirror-image reciprocity to that of equal market access. Then, we ultimately reached the realization that 2,000 years of business traditions in Japan precluded an automatic quid pro quo in market penetration, and this brought us to request simple national treatment.

In the final analysis, we have come to realize that even national treatment leaves major investment impediments unresolved, in that new and fledgling Japanese companies often face many of the same commercial strictures as do foreign firms. The difficulty in market access is not perforce an expression of stubborn ill-will on the part of the Japanese against foreigners. The difficulty resides, rather, in certain features of the internal structure of the Japanese market, notably the distribution system and certain construction bidding practices. Such structural impediments are more responsible for our own sense of frustration at market penetrability than an actual sense on the part of the Japanese of hostility towards foreigners per se.

The effect, nonetheless, is the same; hence the structural impediments initiative. It is, moreover, believed that what would be helpful to foreign investors in Japan would also be beneficial to Japanese consumers themselves, as well as to Japan's business relations globally as a major player in the international economic arena.

As mentioned earlier, there is a large variance in the degree of optimism over these talks. I, personally, choose to be optimistic. The talks are a high-profile moment of opportunity for Japan to show the rest of the world--not only the United States--that it is serious. And the world is watching.

I would just briefly mention that two chief areas of concern in the United States have been competitiveness and national security. On competitiveness, I do not believe that foreign direct investment makes us less competitive. I believe that foreign direct investment is good for our competitiveness, that it stimulates ingenuity and inventiveness, that it stimulates the entrepreneurial spirit, industriousness and efficiency that made America great.

In fact, if we are in any way concerned about our competitive edge, some of the indicators of where the problem lies may show up more revealingly elsewhere. For example, in a comparison between the United States and Japan in matters of evaluating return on investment, market share, and introduction of new products related to R&D, the U.S. responses are symptomatic.

On a scale of zero-to-ten, the importance that an American corporate sampling placed on return on investment in relation to the importance a Japanese sampling placed on return on investment was reported to be 8.1 for the American group and 4.8 for the Japanese. Americans rated the importance of market share at 2.4

on the same scale, while the Japanese rated market share at 4.1. For the introduction of new products, closely related to research and development, the U.S. sample gave a value of .7 on a scale of zero-to-ten, while the Japanese sample rated new products introduction at 3.5. Another study has shown that U.S. companies are spending just about 6 to 7 percent of sales on research and development while Japan is spending 12 to 15 percent.

These are just a few indications of why we cannot simply hurl our competitiveness complaints at foreign investors. It is my view that the American preoccupation with short-term profits over R&D and other activities that would improve our long-term competitiveness are more at fault than foreign direct investment for any erosion of our global competitiveness.

Where there are ultra-company measures, be they tax-related or linked to other local or federal policies that may put U.S. corporations at a disadvantage competitively, let's work on those factors directly, rather than blaming foreign competition. If we cannot face competition at home, how can we expect to be competitive globally?

In a word, foreign competition should inspire and stimulate American innovation. Would the United States have put a man on the moon had the Soviets not launched a Sputnik? Many new technologies in the United States over the past twenty years are directly or indirectly attributable to the Sputnik challenge. The U.S. education system also received a temporary boost. We would only stand to benefit were the Japanese challenge to effect the same kind of impetus to U.S. technological advance and to improvements in our education system.

In the interest of time, I am going to leave national security issues to one or two very competent members of the panel: Dave Tarbell from the International Economic Affairs Office of the Department of Defense, and Steve Canner from Treasury, currently chairing the Committee on Foreign Investment in the United States (CFIUS). CFIUS, as most of you know, is the body that implements the Exon-Florio provisions on national security implications of foreign takeovers.

I will only touch on the two major legislative initiatives in Congress, of which Exon-Florio is one, in anticipation of Steve's upcoming remarks and this afternoon's session on legislative aspects of foreign direct investment.

Exon-Florio, of course, is that amendment to the 1988 Omnibus Trade Act whose purpose is to enhance presidential powers to review and, if necessary, block any foreign acquisition that is deemed potentially harmful to our national security. While, it is my opinion that Exon-Florio is being administered responsibly at this time, one outstanding area of concern is the fact that "national security," for the purposes of Exon-Florio implementation, has not been clearly defined. This leaves open the possibility of a more liberal application of the concept of national security under future administrations, with the restrictive effect that could accompany a broader interpretation of the term.

Other national security safeguards are also in place, largely under the Department of Defense, which Dave Tarbell may review for us in a few moments.

The second major legislative initiative is, of course, the Bryant Bill, requiring broader disclosure for foreign firms investing in the United States. Time does not permit discussion of this bill's provisions, potentialities and pitfalls here. I expect this will be well covered in the legislative session this afternoon. Suffice it to say that the bill, clearly perceived abroad as protectionist, has not become law, and would currently face a presidential veto. It is nonetheless waiting in the wings.

I now cede to the distinguished panel, leaving these and any further issues to be elaborated both by our panel of experts and by the specificity you, the audience, bring to the question and answer period following.

I would just like to close by saying that, in my view, we should welcome Japanese investment, while working for significantly improved access to Japan's markets. Wherever restrictions have been imposed on incoming direct investment--whether in Third World countries, non-market economies, or industrialized nations--the results have been counterproductive. History has shown this to be so.

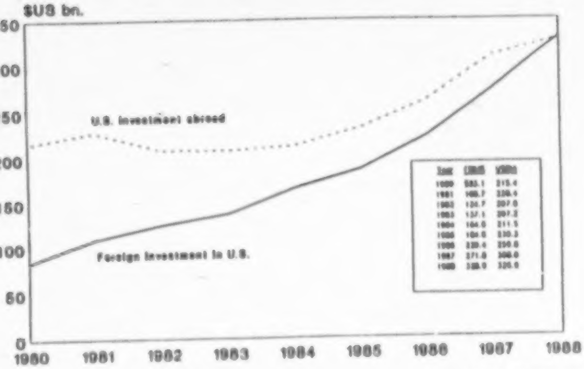
Let me leave you with this final thought: I see in New York harbor a statue with the inscription: "Send me your tired, your poor...." Perhaps we should consider erecting a statue in San Francisco Bay with these words: "We also welcome your energetic, your prosperous...."

Thank you.

Dr. Cynthia Day Wallace is a Senior Fellow in the International Business and Economics Program at the Center for Strategic and International Studies (CSIS) and former Deputy Executive Director of the Investment Negotiation Program of the International Law Institute of Georgetown University Law Center. Dr. Wallace's publications include Foreign Direct Investment in the 1990s: A New Climate in the Third World, Legal Control of the Multinational Enterprise, and Foreign Direct Investment and the Multinational Enterprise. She received her Ph.D. in international law from Cambridge University.

TABLE 1

Cumulative U.S./Foreign Direct Investment Balance

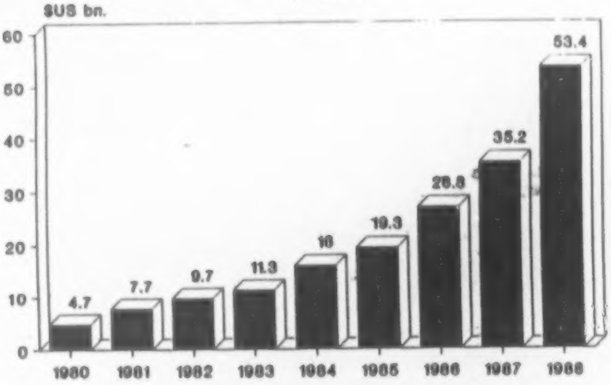


Source: U.S. Department of Commerce

TABLE 2

Japanese Direct Investment in the U.S.

(Cumulative)

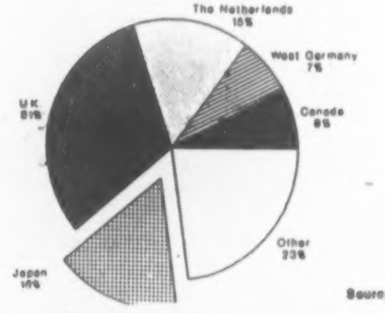


Source: U.S. Department of Commerce

TABLE 3

FDI in the U.S. 1988
Total U.S. $328.9 billion

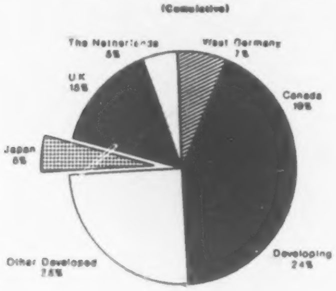
(Cumulative)



Source: U.S. Department of Commerce

U.S. Direct Investment Abroad 1988
Total U.S. $326.9 billion

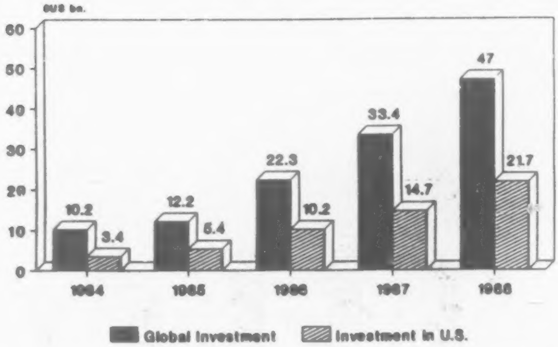
TABLE 4



Source: U.S. Department of Commerce

Japan's Annual Foreign Direct Investment
Global/U.S. Trend

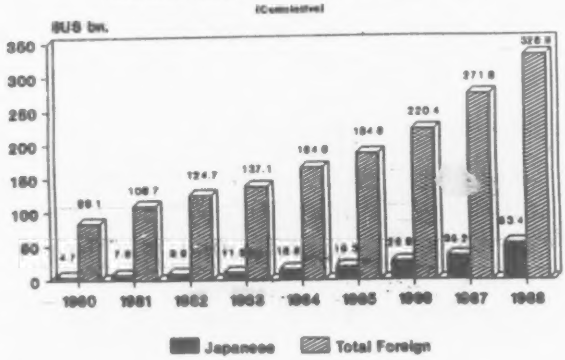
TABLE 5



Source: Japanese Ministry of Finance

Japanese v. Total Foreign Direct Investment in the U.S.

TABLE 6

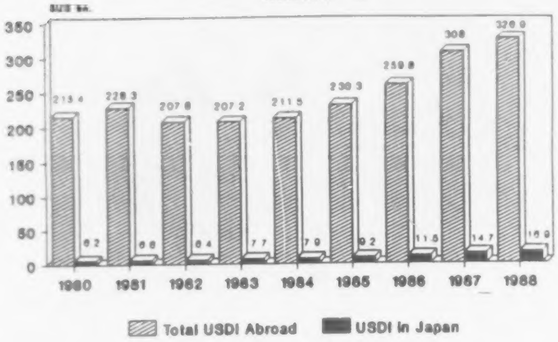


Source: U.S. Department of Commerce

TABLE 7

Total U.S. Direct Investment Abroad v. in Japan

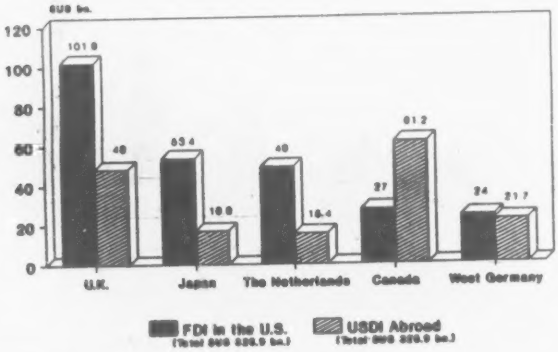
(Cumulative)



Source: U.S. Department of Commerce

TABLE 8

FDI in the U.S. v. U.S. Direct Investment Abroad 1988



Source: U.S. Department of Commerce

TABLE 9

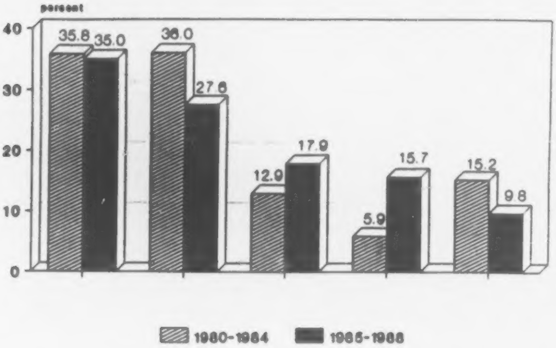
Cumulative Foreign Direct Investment
A 1987-1988 Comparison
(in $US bn.)

Country:	FDI in the US by:		US FDI in:	
	1987	1988	1987	1988
Britain	$79.7	$101.9	$42.0	$48.0
Japan	35.2	53.4	14.7	16.9
Netherlands	49.1	49.0	14.4	15.4
Canada	24.0	27.4	56.4	61.2
W. Germany	20.3	23.9	24.8	21.7

Source: U.S. Department of Commerce

Average Annual Rate of Growth
Foreign Direct Investment in the U.S.

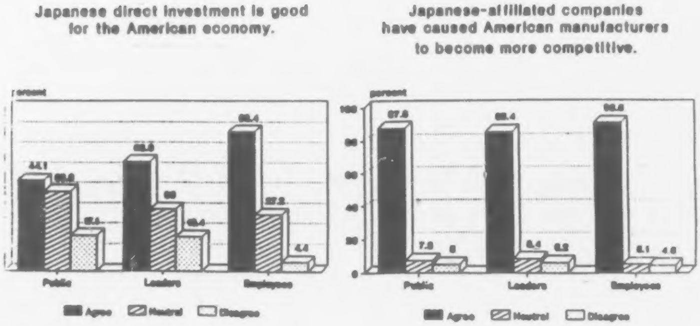
TABLE 10



Source: U.S. Department of Commerce

American Attitudes on Japanese Investment

TABLE 11


Japanese direct investment is good for the American economy.

Japanese-affiliated companies have caused American manufacturers to become more competitive.

Source: Japan Society of New York survey

American Attitudes to Foreign Investment

TABLE 12

Foreign Investment:	Yes	No	Unsure
creates new jobs	59%	37%	4%
brings the best of foreign business techniques	56	39	5
creates more competition and leads to lower prices	54	41	5
Do You Support a Law to:			
prohibit further investment?	40	54	6
require foreign investors to register?	89	8	3

Which:	Japanese	British	West Germans	Arabs	Don't Know:
are most effective in business?	86%	2%	5%	1%	6%
treat their workers best?	43	12	13	2	30
make the best products?	60	4	27	1	8
are the most trustworthy partners?	27	35	10	1	16
should invest more in your state?	30	19	12	3	21

Source: Smick-Medley & Associates, Inc.

How Americans Rate Fairness of U.S. Trading Partners

TABLE 13

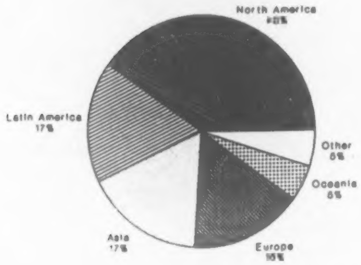
	Fair	Unfair	Unsure
Canada	80%	9%	12%
Britain	72	9	19
West Germany	56	19	25
Taiwan	36	42	23
South Korea	30	42	28
Soviet Union	28	44	28
Japan	29	60	11

Source: American Insight Group

SUPPLEMENTARY TABLES

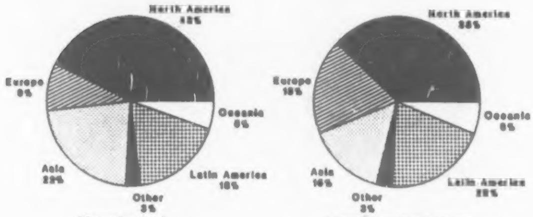
Japan's FDI - All Sectors
Cumulative to April 1989

(U.S. $186.4 billion)



Source: Japanese Ministry of Finance

Japan's Foreign Direct Investment
Cumulative to April 1989

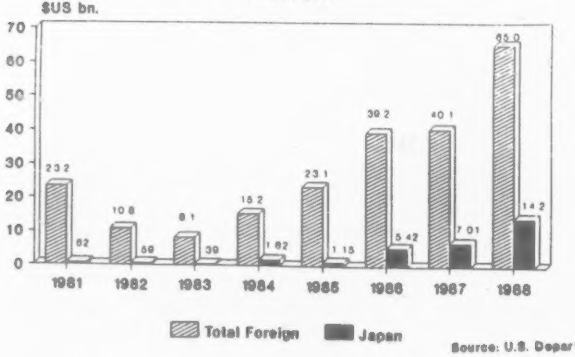


Manufacturing
($49.8 bil)

Non-Manufacturing
($132 bil)

Source: Japanese Ministry of Finance

Investment Outlays to Acquire/Establish U.S. Businesses
(Annual Figures)



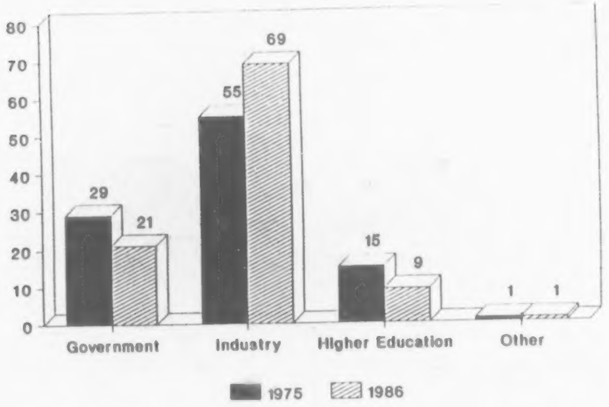
Source: U.S. Department of Commerce

Japanese Majority Ownership of U.S. Manuf. Companies
(Total 796 companies with 1101 plants)

State	No. Japanese plants
California	206
Ohio	83
Illinois	77
Georgia	61
Michigan	53
New Jersey	46
Texas	45
Indiana	42
North Carolina	41
Kentucky	41
Tennessee	36
Washington	35
New York	32

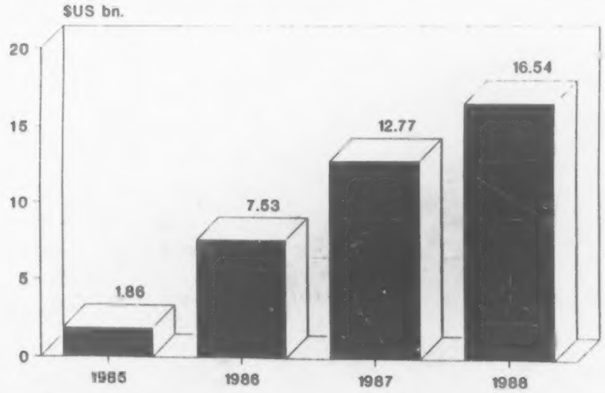
Source: Japanese Economic Institute

Japanese R & D



SOURCE: NATIONAL SCIENCE FOUNDATION

Japanese Investment in U.S. Real Estate
(Annual Figures)



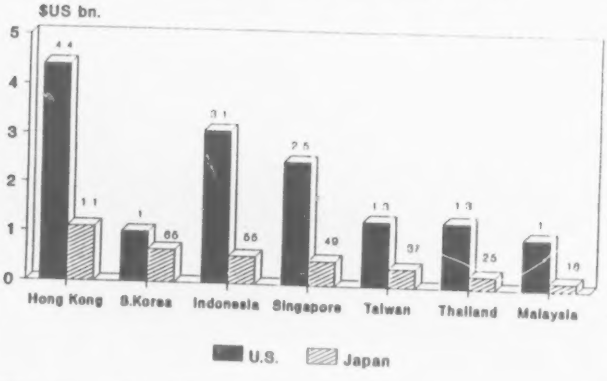
Source: Kenneth Leventhal & Co

Japan's Investment in U.S. Real Estate 1988

Metro Area	Amount (in millions)	% of total
Los Angeles	$3049	18
New York	2802	17
Chicago	1871	11
Honolulu	1325	8
San Francisco/Oakland	740	5
Atlanta	718	4
Boston	683	4
Washington, D.C.	638	4
Anaheim	506	3
Dallas	505	3
San Diego	421	3
Seattle	341	2
Other Areas	2945	18
Total	$16544	100

Source: Kenneth Leventhal & Co.

Foreign Direct Investment
Selected Asian Countries (1987)



Sources: Japanese Ministry of Finance
U.S. Department of Commerce

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